Supreme Court, U.S.
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No. 80-659

# In the Supreme Court of the United States

**October Term, 1980**

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,
*Petitioners,*

vs.

PEAT, MARWICK, MITCHELL AND COMPANY,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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October, 1980

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## QUESTIONS PRESENTED

Where the Court of Appeals held that an accounting firm knowingly made misstatements of material facts relating to restrictions upon stock offered shareholders in a corporate merger proxy statement, and did not act to correct the resulting false impression, was it error for the Court of Appeals to

(a) define "scienter" as requiring proof that "a desire to deceive, defraud or manipulate motivated" the defendant and base its review on a conclusion the record contained insufficient evidence of "motive for deception"?

(b) Require evidence that "a decision to deceive, defraud or manipulate motivated" the defendant to sustain a judgment for violation of SEC Rule 14a-9 (a)?

(c) Ignore evidence of knowing misrepresentation and intentional failure to correct previous misleading statements in reaching the conclusion the trial court was clearly erroneous?

(d) Hold an accountant was not a primary participant though it misstated material information and failed to correct it when directly notified of the false statement?

## PARTIES

Mary Lillian Adams brought this action in her own name in behalf of all other persons similarly situated. Class was subsequently certified. The following persons intervened through Charles E. Rader, Esq.: Paul W. Mankin; Blendine McRae; Charles E. Rader; May F. Nichols; Della Ezell Widener; Elizabeth Coe Carman; Iliff C. Fisher; Grace F. Chrisman; Albert Houston Franklin; Lucille Franklin.

The following persons intervened through Leon Jourolmon, Esq.: Barry J. McKean; John Stephen McKean, in his own name and as Trustee for John Stephen McKean, Jr., a minor, and as Trustee for Melody Anne McKean, a minor; Richard S. Bagwell; Laura J. Bagwell; Anne J. Terrell; Mary J. Foust; Myvanwy J. Boyd; Neil Jourolmon; Anne Dosser Jourolmon; Lois Jourolmon; Leon Jourolmon, Jr.; Martha P. Jourolmon; Leon Jourolmon, III;

Mr. Jourolmon is now deceased; no substitute counsel for that group of intervening plaintiffs has, so far as known to petitioners, appeared.

Named as original defendants were: Standard Knitting Mills, Inc., successor by merger to SKM, Inc. and Standard Knitting Mills, Inc., each a Tennessee corporation; Chadbourn, Inc.; J. E. Gettys; Jackson C. Kramer; Harry M. Nacey, Jr.; E. B. Rodgers; J. B. Woolsey; J. Chadbourn Bolles; Thomas N. Roboz; Curt Seifart; E. M. Hicks, Jr.; J. W. Johnston and Peat, Marwick, Mitchell & Co.

Partial settlement of plaintiffs' claims were made prior to trial with all defendants except respondent.

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit is reported at 623 F.2d 422 (1980), and is reproduced at pages A1-A48 of the Appendix. The Order Denying Petition for Rehearing is at A134 of the Appendix. The findings of fact and conclusions of law of the United States District Court for the Eastern District of Tennessee, Northern Division, are unofficially reported at Federal Securities Law Report (CCH) ¶95,683 (1976) and are reproduced at pages A49-A133 of the Appendix.

## STATUTES AND RULES INVOLVED

Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j provides as follows:

SECURITIES EXCHANGES

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, § 10, 48 Stat. 891.

Rule 10b-5 (17 C.F.R. § 240.10b-5) provides as follows:

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

[13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n provides:

§ 78n. Proxies

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

Rule 14a-9 (17 C.F.R. § 240.14a-9) provides as follows:

§ 240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of

proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

## JURISDICTION

The Court of Appeals' decision sought to be reviewed herein was dated and entered on May 2, 1980. An Order denying rehearing *en banc* was entered on July 23, 1980. (Appendix A134.) Accordingly, the instant Petition is timely. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

The Court of Appeals' decision on which this Petition is taken is appropriate for review on certiorari under Supreme Court Rule 17.1(a) and (c) in that: on the issue of an acceptable definition of scienter under *Ernst & Ernst v. Hochfelder,* it is in conflict with decisions of seven other Circuit Courts of Appeal and with an earlier decision of the same Circuit which decided the present case; on the requirement of proof of scienter to support a violation of the SEC proxy regulation, 14a-9, it is in conflict with decisions of five other Circuits; the Court of Appeals ignored a controlling decision of this Court in review of the "clearly erroneous" standard; the Court of Appeals decided important questions of federal law which (i) have not been, but should be settled by this Court, and (ii)

are in conflict in principle with the decisions of this Court in *Aaron v. SEC,* 100 S. Ct. 1945 (1980), *Standefer v. United States,* 100 S. Ct. 1999 (1980), and *Chiarella v. United States,* 100 S. Ct. 1108 (1980).

## STATEMENT OF THE CASE

### Facts

Standard Knitting Mills, Inc. ("Standard") entered into a merger contract with Chadbourn, Inc. ("Chadbourn") subject to approval of Standard's shareholders. Under the agreement, Standard shareholders were offered a Chadbourn preferred stock redeemable at twenty percent per year, for a fixed price, commencing five years after the merger. Respondent certified Chadbourn's financial statements included within the Standard proxy which solicited votes for the merger. Respondent prepared the notes to Chadbourn's financial statements. (Joint Appendix 678a-684a, 2438a, 3117a.) In doing so, respondent was aware of restrictions upon payment of dividends and redeeming stock in an indenture and bank loan agreement underlying $18 million of Chadbourn debt. (JA 2032a-2033a.) The indenture provided Chadbourn will "not declare or pay any dividends or make any distribution on or with respect to its capital stock . . ."; the loan agreement provided Chadbourn would not "pay any dividend on its capital shares of any class or make any distribution to any shareholders as such . . . or purchase, redeem or otherwise acquire for value any shares of its stock of any class . . ." (JA 2195a, 2313a-2314a.) In describing the foregoing restrictions, respondent substituted "common" for "capital" (JA 2082a), and wrote a note which disclosed, "as to the note payable to three banks, the Company has agreed to various restrictive provisions includ-

ing . . . the payment of dividends on common stock in excess of . . ." (JA 690a-693a, 2040a-2042a.) The indenture was stated to contain "restrictive covenants but they are less restrictive than those contained in the note agreement . . ." (JA 690a-693a, 2040a-2042a.)

The Standard proxy was printed and mailed March 27, for a stockholders' meeting scheduled April 22. Not later than March 31 or April 1, Chadbourn's attorney called the incorrect language of the footnote to respondent's attention. (JA 2044a, 2047a.) Nothing was done to inform the Standard shareholders of the false statement, although in two other instances during that interim, respondent corrected the disclosure for Chadbourn's use in a different proxy statement and in a separate and different loan agreement which required approval of Chadbourn's shareholders. (JA 3252a-3253a, 3257a, 2595a, 2482a.)

The Court of Appeals held a false statement was knowingly made by respondent concerning material facts, directed to the persons respondent knew would rely on the specific information:

> Peat failed to disclose fully in the financial statement the restrictive effect of the loan agreement and indenture on Chadbourn preferred stock. After each entry relating to long-term capitalization, the financial statement directs the attention of the reader to explanatory note 7. Note 7 alone pertains to Chadbourn's long-term debt. Missing from the note is any reference to limitations that the debt agreements placed on Chadbourn preferred stock.
>
> Only in notes 7(c) and 7(d) does Peat mention the restrictive provisions. Note 7(c), which discusses the loan agreement, reports only that 'the Company has agreed to various restrictive provisions including

. . . the payment of dividends on common stock in excess of $2 million plus earnings subsequent to August 2, 1969.' Note 7(d) describes the indenture. It says that 'the indenture has certain restrictive covenants, but they are less restrictive than those contained in the [loan] agreement.' Thus, there is no indication in either note that the long-term debt restrictions affected the redemption and earnings of preferred stock.

From notes 7(c) and 7(d), a reader easily could derive the following mistaken impression: The loan agreement contains certain restrictions on the payment of dividends by Chadbourn. As note 7(c) explicitly says, the loan agreement restrictions relate to the payment of dividends 'on common stock.' The indenture contains limitations that are 'less restrictive' than those created by the loan agreement. Since the limitations of the loan agreement apply only to common stock, the reader mistakenly could reason that the 'less restrictive' indenture constraints appear to have no broader sweep. What note 7 conveys to the reader is the erroneous notion that neither the loan agreement nor the indenture restrictions apply to Chadbourn preferred stock. (Appendix A9-A10.)

* * *

The finding of the District Court that Peat acted with scienter in making the omissions is nevertheless clearly erroneous. *We find in the record nothing to indicate that a desire to deceive, defraud or manipulate motivated Peat to omit from the financial statement information regarding the applicability of long-term debt restrictions.* (Appendix A10.) [Emphasis added.]

* * *

. . . The Standard proxy statement was mailed to its stockholders on March 27, 1970. Between March 23,

> 1970, and April 1, 1970, Chadbourn's outside counsel telephoned Freeze, the Peat manager in charge of the Chadbourn audit, and told him that a description of restrictions relating to Chadbourn's stock had been inserted in the forepart of the Standard proxy statement prior to mailing. The lawyer called to his attention the difference in the description in the proxy statement and the footnote, pointing out that the footnote said 'common' rather than 'capital stock of any class.' . . . . Thereafter, footnote 7(c) was not amended, and no effort was made to call the discrepancy to the attention of Standard stockholders or officials. (Appendix A10-A11.)

The dissent correctly observed the trial court "could rightly infer that the reason Freeze [respondent's draftsman] did not correct the original was because it would have defeated the merger . . . (Appendix A40.)

Federal jurisdiction in the court of the first instance was grounded upon Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78aa).

## ARGUMENT

### I

**The decision below directly conflicts with decisions of the District of Columbia, Second, Ninth and Tenth Circuits, and an earlier decision of the Sixth itself, if the test of scienter is knowledge, not motive or desire; and conflicts with decisions of the Second, Third, Fifth, Seventh, Eighth, Ninth and Tenth Circuits if the test of scienter is one of recklessness.**

The Court defined scienter as embracing a "desire to deceive, defraud or manipulate motivated Peat" (Appendix A10) and searched the record for a "motive for deception". (Appendix A11.) This test was improper. This Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) does not require proof of motive or narrow the proscription of Section 10(b) which is not limited to conduct that is "manipulative"; it applies to conduct which is "manipulative *or deceptive*" (emphasis added). Petitioners proved "deceptive" conduct. The Court of Appeals upheld that proof:

> What note 7 conveys to the reader is the erroneous notion that neither the loan agreement nor the indenture restrictions apply to Chadbourn preferred stock. (Appendix A9.)
>
> * * *
>
> Peat became aware that note 7 incorrectly described the debt limitation several weeks before the merger vote occurred. The Standard proxy statement was mailed to its stockholders on March 27, 1970. Between March 23, 1970, and April 1, 1970, Chadbourn's outside counsel telephoned Freeze, the Peat manager in charge of the Chadbourn audit, and told him that a description

> of restrictions relating to Chadbourn's stock had been inserted in the forepart of the Standard proxy statement prior to mailing. The lawyer called to his attention the difference in the description in the proxy statement and the footnote, pointing out that the footnote said 'common' rather than 'capital stock of any class.' (Appendix A10.)

Respondent's knowledge was sufficient to impose liability. The term "scienter" refers not to one's purpose or desire but rather to one's knowledge.[1] The Court in *Hochfelder,* in describing scienter as a mental state "embracing intent to deceive, manipulate, or defraud," 425 U.S. at 194 n.12, noted that Section 10(b) "was intended to proscribe knowing or intentional misconduct." 425 U.S. at 197.

Decisions of four other Courts of Appeals, in addition to an earlier decision of the Sixth Circuit, have held the scienter standard under Section 10(b) does not require proof that respondent "deliberately and cold-bloodedly set out to conceal information . . .," but rather that it requires only that misstatements or omissions be made "with knowledge." *See, Nelson v. Serwold,* 576 F.2d 1332, 1337-1338 (9th Cir. 1978), *cert. denied,* 99 S. Ct. 464 (1978); *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d 38 (2d Cir. 1978), *cert. denied,* 439 U.S. 1039 (1978); *Mawood & Co. v. Securities and Exchange Commission,* 591 F.2d 588, 595 (10th Cir. 1979) (willful or reckless behavior); *Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1025 (6th Cir. 1979) (mere negligence is not enough); and *SEC v. Falstaff Brewing Corporation,* No. 79-1467 (D.C. Cir., May 29, 1980) ("Knowledge means awareness of the underlying facts, not the labels that the law places on those facts. Except

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1. "Scienter" is the Latin word for "knowingly." Webster's New International Dictionary of the English Language. (2d ed. 1957).

in very rare instances, no area of the law—not even the criminal law—demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of those actions suffices."). (At Slip. Op. pp. 29, 30.)

Reckless conduct has been held actionable by seven other Circuits. The Court in *Hochfelder* recognized that the term "scienter" is understood in certain areas of the law to encompass the concept of recklessness, but stated that it was unnecessary in that case to address "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5." 425 U.S. at 194 n.12. The issue was again reserved in *Aaron v. SEC,* (No. 79-66) 100 S. Ct. 1945, n.5 on p. 1950.

Subsequent to *Hochfelder,* decisions of seven other Courts of Appeals have concluded that recklessness satisfies the *Hochfelder* scienter standard. *See, Kiernan v. Homeland, Inc.,* 611 F.2d 785, 787 (9th Cir. 1980); *Spectrum Financial Companies v. Marconsult,* 608 F.2d 377, 381 (9th Cir. 1980); *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.,* 602 F.2d 478, 484 (2d Cir. 1979); *Heizer Corp. v. Ross,* 601 F.2d 330, 334 (7th Cir. 1979); *McLean v. Alexander,* 599 F.2d 1190, 1197-1198 (3d Cir. 1979); *Mawod & Co. v. Securities and Exchange Commission,* 591 F.2d 588, 596 (10th Cir. 1979); *Nelson v. Serwold,* 576 F.2d 1332, 1337-1338 (9th Cir. 1978), *cert. denied,* 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d 38 (2d Cir. 1978), *cert. denied,* 439 U.S. 1039 (1978); *Coleco Industries, Inc. v. Berman,* 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied,* 439 U.S. 830, *rehearing denied,* 439 U.S. 998 (1978); *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978); *Wasson v. Securities and Exchange Commission,* 558 F.2d 879, 887 (8th Cir. 1977); *Sanders v. John Nuveen & Co., Inc.,* 554 F.2d 790, 792 (7th Cir. 1977);

*Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

In this case, the definition of scienter employed by the Court of Appeals substitutes the term "desire to deceive" for the test of cognizable "intent to deceive." The decision below goes beyond the definition of scienter by this or any other Court, and imposes a higher standard than is required, even in a criminal context. *See United States v. Carter*, 311 F.2d 934 (6th Cir. 1963); *United States v. Charnay*, 537 F.2d 341, 358 (9th Cir. 1976), *cert. denied*, 429 U.S. 1000 (1976).

This error was clearly recognized in the dissenting opinion which concluded "The majority opinion is inconsistent with the holdings in these cases and with the reasoning of the Supreme Court in *Chiarella v. United States*, No. 78-1202, 48 L.W., No. 36, pp. 42-50" (Appendix A44), and "impliedly overrules our decision in *Mansbach*." (Appendix A43, n.1.)

## II

**The decision conflicts in principle with that of Aaron v. SEC, 100 S. Ct. 1945, conflicts with this Court's decision in Standefer v. United States, 100 S. Ct. 1999 (1980), and conflicts with two other Courts of Appeals by requiring proof of scienter to sustain a violation of Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9.**

The panel's conclusion that a finding of scienter is required in order to prove a violation of Section 14(a) of the Securities Exchange Act and Rule 14a-9 is in conflict in principle with the decision of this Court in *Aaron v. SEC*, No. 79-66, 100 S. Ct. 1945 (1980). It fails to recognize that, unlike Section 10(b), neither Section 14(a) nor Rule 14a-9 uses language which would even suggest a require-

ment that the violator must act with scienter, much less "motive" scienter.

Section 14(a) of the Securities Exchange Act of 1934 grants the Commission authority to prescribe rules relating to proxies as are "necessary or appropriate in the public interest or for the protection of investors." Rule 14a-9(a) prohibits any proxy solicitation which is "false or misleading with respect to any material fact, or which omits to state any material fact" necessary to make statements not "false or misleading" or to correct earlier statements which have become "false or misleading."

The decision of the Court below is in conflict with this Court's reasoning in *Aaron*:

> By contrast, the language of §17(a)(2), which prohibits any person from obtaining money or property 'by means of any untrue statement of a material fact or any omission to state a material fact' is devoid of any suggestion whatsoever of a scienter requirement. As a well-known commentator has noted, '[t]here is nothing on the face of Clause (2) itself which smacks of *scienter* or intent to defraud.' III L. Loss Securities Regulation 1442 (2d ed. 1961). In fact, this Court in *Hochfelder* pointed out that the similar language of Rule 10b-5(b) 'could be read as proscribing . . . any type of material misstatement or omission . . . that has the effect of defrauding investors, whether the wrongdoing was intentional or not.' 425 U.S. at 212.
>
> Finally, the language of §17(a)(3), under which it is unlawful for any person 'to engage in any transaction, practice, or course of business which *operates or would operate* as a fraud or deceit,' (emphasis added) quite plainly focuses upon the *effect* of particular conduct on members of the investing public,

rather than upon the culpability of the person responsible. This reading follows directly from *Capital Gains*, which attributed to a similarly worded provision in §206(2) of the Investment Advisers Act of 1940 a meaning that does not require a 'showing [of] deliberate dishonesty as a condition precedent to protecting investors.' 375 U.S. at 200.

It is our view, in sum, that the language of §17(a) requires scienter under §17(a)(1), but not under §17(a)(2) or §17(a)(3). Although the parties have urged the Court to adopt a uniform culpability requirement for the three subparagraphs of §17(a), the language of the section is simply not amenable to such an interpretation. This is not the first time that this Court has had occasion to emphasize the distinctions among the three subparagraphs of §17(a). In *United States v. Naftalin*, 441 U.S. 768, 774, the Court noted that each subparagraph of §17(a) 'proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections' (Footnote omitted.) Indeed, since Congress drafted §17(a) in such a manner as to compel the conclusion that scienter is required under one subparagraph but not under the other two, it would take a very clear expression in the legislative history of congressional intent to the contrary to justify the conclusion that the statute does not mean what it so plainly seems to say. 100 S. Ct. 1955-1956.

To petitioner's knowledge, except for the decision of the panel in this case, no other federal court has ruled that scienter, rather than negligence, is required. *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777-778 (3d Cir. 1976); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281,

1300-1301 (2d Cir. 1973); and *see, Norte & Co. v. Huffines,* 304 F.Supp. 1096, 1109-1110 (S.D.N.Y. 1968), *affirmed in pertinent part,* 416 F.2d 1189 (2d Cir. 1969), *cert. denied sub nom. Muscat v. Norte & Co.,* 397 U.S. 989 (1970).

The panel, in concluding that scienter was required in order to hold the accounting firm liable under Section 14(a), placed particular emphasis on its perception of the respondent's liability for the erroneous financial statements as being one of secondary liability. This is in conflict with this Court's decision in *Standefer v. United States,* 100 S. Ct. 1999 (1980). And *see, Securities and Exchange Commission v. Coffey,* 493 F.2d 1304, 1315 n.24 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975) (where the Court viewed an accountant who prepares a dishonest financial statement as a "primary participant in a violation" rather than a secondary participant).

## III

**The Court ignored evidence in the record in conflict with this Court's admonition in Zenith Corporation v. Hazeltine.**

The Court tried the case de novo notwithstanding the decision of the Supreme Court in *Zenith Corporation v. Hazeltine,* 395 U.S. 100 (1969).

The panel ignored evidence (or stated incorrectly that evidence did not exist) proving scienter. After a two week trial, at which twelve witnesses appeared, six as experts, the trial court found ". . . defendant acted willfully, with intent 'to deceive' and 'manipulate' and in 'reckless disregard for the truth' ". (Appendix A90.)

Important evidence was recited by the dissent which upholds that conclusion. It is set forth here because of the majority's failure to refer to or account for it:

It is clear that Peat had full knowledge of these restrictions when it prepared the Standard proxy financial statements and certified that the financial statements . . . accurately described the financial condition and debt structure of Chadbourn. . . . [B]etween March 23, 1970, and April 1, 1970, prior to the merger, Hugh Freeze, the Peat manager in charge of the Chadbourn audit, received a phone call from Peat's attorney Herbert Browne, Jr., a member of the law firm of Helms, Mullis & Johnston, the firm that prepared parts of the proxy. Brown[e] informed Freeze that the use of the word 'common' in footnote 7(c) of the Peat audit was erroneous. Freeze then crossed out the word 'common' on his copy of a preliminary draft of the Standard proxy footnote and wrote the word 'capital' underneath it. [JA 708a, 709a, Ex. 61, JA 2631a, Ex. 42, 43, JA 2043a-2044a, 2434a, 2435a.] Peat, however, did not alter the proxy, or, if the proxy had already been mailed, Peat took no steps to notify Standard shareholders or the SEC to correct the alleged error before the Standard shareholders voted on the acquisition of Standard by Chadbourn. [JA 709a, 2045a-2046a.] The District Court could rightly infer that the reason Freeze did not correct the original was because it would have defeated the merger as the Standard shareholders would not have approved it.

There is other direct evidence that Peat had actual knowledge of the alleged error in footnote 7 of the proxy statement before the merger vote was taken. At approximately the same time it was preparing the Standard proxy Peat was also drafting a proxy containing the same financial statement for use in soliciting votes for the acquisition of Continental Strategics Corporation by Chadbourn (the Continental

> proxy materials). [JA 2054a.] The Continental proxy, like the UHM proxy, contained the correct word 'capital' in footnote 7(c). The Continental proxy was mailed on April 8, 1970, approximately two weeks before the vote on the Standard merger. The Continental proxy was not mailed to Standard shareholders because the Standard merger had not yet been consummated.
>
> As indicated, *supra,* Peat also prepared the UHM proxy which contained the word 'capital' in footnote 7(c). In a letter to the SEC dated April 20, 1970, two days before the Standard merger vote, counsel for Chadbourn sent to SEC copies of the UHM proxy containing the proper word. (Appendix A39-A40.)

In addition to evidence respondent

> (a) failed to correct the error which had been called to its attention at least twenty-two days before the Standard shareholders' vote, admittedly knowing of the false statement (JA 2044a-2045a),
>
> (b) knew of the intended users of the information, recipients of preferred stock (JA 1627a, 2036a, 2037a, 2047a),
>
> (c) corrected the language in two other financial statements (JA 3252a-3253a, 3257a, 2475a, 2476a, 2482a, 2595a), and
>
> (d) reverted to the false language in the first annual report disseminated to the class (JA 729a-731a, 2267a),

the Record contained statements by a partner and an outside expert for respondent. The former testified correct disclosure was "mandatory" (JA 2144a-2145a), and was "the type of disclosure that says it has to be there" (JA

2146a). Respondent's expert Weston, a retired member of a major accounting firm, testified that "It would be of significance to the Standard shareholders to know whether there were restrictions on the payment of dividends," that had respondent discovered the accuracy in the footnote, "I personally would find it hard to believe that they would not make the change. It's a reasonable position; unreasonable not to do it". (JA 1690a-1691a.) "I would have changed it. I think it unreasonable not to have changed it." (JA 1693a.)

The dissenting opinion correctly summarized this as "evidence of deliberate fraud . . ." (Appendix A41.)

And finally, the majority conclusion, that

> "The evidence simply suggests a mistake, an oversight, the failure to foresee a problem." (Appendix A11.)

was not based upon *any evidence*. Respondent's author of the footnote nowhere so testified. In pre-trial depositions, he insisted the footnote "adequately disclose[d]" the restrictions (JA 2069a), although he admitted "capital is more adequate." (Id.) At trial he insisted the footnote was "imprecise" (JA 2042a), and "not materially incorrect". (JA 2042a.) Only when the Court admonished him concerning his credibility in how "readily or otherwise you respond to questions" (JA 2042a) did he finally admit "that this footnote is not correct". (JA 2043a.)

The only time he testified on the *cause* of *any* error was not with respect to the financial statement contained in the Standard proxy statement, but with respect to the financial statement contained in the subsequent annual report sent to the stockholders after the merger. He characterized his reversion to the incorrect language for the annual report as a "drafting error." (JA 2079a, 2080a.) He nowhere explained the incorrect language in the proxy

statement was "a mistake, an oversight, the failure to foresee a problem" though the majority below so held. (Appendix A11.)

The trial court found, "The court has not found and Peat has not suggested any other reasonable explanation for defendant's conduct in all of the particulars discussed by the court throughout this section." (Appendix A65.) Had the majority followed *Zenith Corporation v. Hazeltine,* 395 U.S. 100, considered "the entire evidence," and given the trial court obligatory deference in considering oral testimony, drawing inferences and reconciling conflicts therein, the trial court would have been affirmed because its decision was based upon substantial evidence.

Petitioner submits this decision so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

## CONCLUSION

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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October, 1980

APPENDIX

Nos. 78-1111-2

# UNITED STATES COURT OF APPEALS

## FOR THE SIXTH CIRCUIT

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,
*Plaintiffs-Appellees,*

BARRY J. McKEAN, ET AL., PAUL W. MANKIN, ET AL.,
*Intervenors-Appellees,*

v.

STANDARD KNITTING MILLS, INC., ET AL.,
*Defendants,*

PEAT, MARWICK, MITCHELL AND COMPANY,
*Defendant-Appellant.*

ON APPEAL from the United States District Court for the Eastern District of Tennessee.

Decided and Filed May 2, 1980.

Before: WEICK, ENGEL and MERRITT, Circuit Judges.

MERRITT, Circuit Judge, delivered the opinion of the Court in which ENGEL, Circuit Judge, joined. WEICK, Circuit Judge, (pp. 28-48) filed a separate dissenting opinion.

MERRITT, Circuit Judge. In this securities fraud case, Peat, Marwick, Mitchell & Co., herein referred to as "Peat," a firm of certified public accountants, appeals from a judgment of the District Court in the amount of $3.4 million, plus pre-judgment interest, plus attorneys' fees of $1.2 million. The suit is a

class action based upon causes of action implied under §§ 10 (b)[1] and 14(a)[2] of the Securities Exchange Act of 1934 and SEC Rules 10b-5[3] and 14a-9.[4] It is based on an allegedly false

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1 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

2 It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title.

15 U.S.C. § 78n(a) (1976).

3 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1979).

4 (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, contain-

proxy solicitation issued in order to gain shareholder approval of a merger between two corporations, Chadbourn, Inc. and Standard Knitting Mills, Inc., herein referred to as "Chadbourn" and "Standard." The primary issue is whether Peat is liable for a negligent error – the failure to point out in the proxy statement sent to stockholders of the acquired corporation that certain restrictions on the payment of dividends by the acquiring corporation applied to preferred as well as common stock. We hold that in the context of this case Peat is not liable for such conduct and reverse the District Court on the issue of liability.

## I. STATEMENT OF FACTS RESPECTING RESTRICTIONS ON PAYMENT OF DIVIDENDS

### A. General Terms and Purpose of the Merger

In April 1970, Chadbourn, Inc., a relatively profitable North Carolina hosiery manufacturer listed on the New York Stock Exchange, acquired all of the common stock of Standard Knitting Mills, Inc., a smaller, publicly-held, Knoxville, Tennessee, textile manufacturer, whose stock traded from time to time, although infrequently, in the over-the-counter market. On April 22, 1970, Standard's stockholders at a special meeting agreed to exchange their stock for a package of Chadbourn securities. The meeting occurred after the stockholders received the proxy statement a month earlier from Standard transmitting information about the proposed merger and Chadbourn's financial condition. The proxy statement contained

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ing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9(a) (1979).

a recommendation by Standard's management favoring the merger, as well as financial statements of Chadbourn prepared by its accountants, Peat Marwick.

Before the merger, Standard's stock traded at around $12.00 a share, although its book value was carried at approximately $21.00 a share, and Chadbourn's stock fluctuated between $8.00 and $14.00 a share. Standard's stockholders exchanged each share of Standard common for 1/10 of a share of Chadbourn common, plus 1-1/2 shares of Chadbourn convertible, cumulative, preferred stock. The Chadbourn preferred was the main part of the package. According to the terms of the merger agreement, each share of Chadbourn preferred stock given in exchange was supposed to pay annual cash dividends of $.46-2/3 a share, and Chadbourn was supposed to redeem 20% of these preferred shares each year at $11.00 a share, beginning in 1975. Each preferred share carried a conversion privilege allowing the preferred stockholder to convert a share of preferred into 6/10 of a share of Charbourn common. The general purpose of the package appears to have been to give each Standard shareholder a set of Chadbourn securities with approximately the same market value as their Standard shares but with more liquidity and higher dividends.

Approximately a year after the merger, Chadbourn's sales of hosiery plummeted unexpectedly, and it suffered a loss of $17 million. This loss wiped out its retained earnings and left it with a capital deficit of $7 million. Chadbourn now was unable to redeem or pay dividends on the preferred stock. In October 1972, the former Standard stockholders sued Chadbourn, Standard, their management, their lawyers and the appellant, Peat, which was, as previously stated, the accounting firm that prepared and certified Chadbourn's financial statements in the proxy materials. Plaintiffs entered into a settlement agreement with the defendants other than Peat, under which the former Standard shareholders were awarded control of Chadbourn, renamed "Stanwood Corporation." The District Court did not take into account the value of the

settlement received by the plaintiffs in determining damages against Peat. Since we reverse the findings of the District Court on liability, we need not reach questions concerning the measure of damages and the award of attorneys' fees.

### B. Restrictions on the Use of Retained Earnings Contained in the Chadbourn Loan Agreements

The first restriction on retained earnings is in a 5-year term loan agreement Chadbourn made with three banks in September, 1969. Chadbourn borrowed $6 million from the banks repayable in installments over the 5-year period. In order to protect the banks, the loan agreement contained a provision which prohibited Chadbourn and its subsidiaries in any year during the term of the loan from redeeming or paying dividends "on its *capital* shares of any class" in an amount in excess of $2 million, less the amount of the repayments on the loan, plus future earnings after the 1968-69 fiscal year.[5] These restrictions would apply to dividend payments on Chadbourn preferred shares issued to Standard shareholders (amounting annually to approximately $450,000) and would apply as well to any distributions to redeem these shares.

The second debt agreement was a little less restrictive. The second contractual restriction on paying out retained earnings is in another debt agreement which Chadbourn also entered into in 1969. Chadbourn borrowed $12.5 million in exchange for an issue of convertible, subordinated debentures. The effect of these restrictions on dividends and distri-

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[5] In August, 1967, at the beginning of Chadbourn's 1967-68 fiscal year, Chadbourn had retained earnings of $4.7 million. Its net earnings during the 1967-68 year were $1.6 million so that retained earnings in August, 1968, at the beginning of the fiscal year 1968-69 were approximately $6.3 million. Its net earnings during the 1968-69 fiscal year were $3.1 million so that retained earnings in August, 1969, at the beginning of the 1969-70 fiscal year were approximately $9.3 million. At this time stockholder equity, consisting of total capital of approximately $18.3 million plus these retained earnings, was $27.7 million.

butions was similar, except that under this agreement Chadbourn was free to use its 1968-69 net earnings of $3.1 million, as well as future earnings, for the payment of dividends and stock redemptions.

The net effect of both sets of restrictions on dividends and redemptions, when taken together, was that Chadbourn would either have to continue to make money or refinance its indebtedness in order to meet fully its future dividend and redemption obligations on the preferred stock issued to Standard's shareholders. As is explained above, when the bottom dropped out of its hosiery market and its retained earnings a year after the merger, it could do neither.

### C. The Description of the Restrictions on Retained Earnings in the Proxy Statement

Standard's proxy statement dated March 27, 1970, contained a 35-page description of the terms of the transaction and its tax-free nature, comparative earnings and stock prices of Standard and Chadbourn and a description of their history, business, managements and properties. The text was followed by 18 pages of financial statements of both companies, including the opinions of Peat with respect to the Chadbourn financial statements and of Ernst & Ernst with respect to the Standard financial statements.

The plan for the exchange of Standard stock for Chadbourn stock was set out at pages 4-8 of the text under the heading "SUMMARY OF PLAN." Pages 6-7 of this portion of the proxy statement accurately describe the two sets of restrictions as follows:

> Under the provisions of a term loan with three banks maturing October 1, 1974, Chadbourn cannot, without the consent of such banks, [1] declare any dividend or [2] make any distribution (other than common stock dividends), or [3] acquire any of its stock if, after such action, the aggregate of all dividends (other than stock

> dividends), other distributions to stockholders and all amounts paid for the acquisition of its stock plus the amounts of all payments made on the term loan, would exceed $2,000,000 plus Chadbourn's consolidated net earnings since August 2, 1969. The Indenture dated as of March 15, 1969 hereinabove referred to contains certain restrictions on the payment of dividends on capital stock, however, such are less restrictive than those contained in the term loan agreement.

Chadbourn's financial statements as of August 2, 1969, and Peat's opinion, dated October 21, 1969, were published in the back of the March 27, 1970, Standard proxy statement. The liabilities and stockholders' equity side of the balance sheet was shown on page F-5 of the proxy statement. This page sets out amounts for current installments of long-term debt, the non-current portion of long-term debt, and "stockholders' equity," which referred in turn to certain notes, including footnote 7.

Footnote 7, paragraphs (c) and (d) erroneously described the two sets of restrictions as follows:

> (c) As to the note payable to three banks, the Company has agreed to various restrictive provisions including those relating to maintenance of minimum stockholders' equity and working capital, the purchase, sale or encumbering of fixed assets, incurrance [sic] of indebtedness, the leasing of additional assets and the payment of dividends *on common stock* in excess of $2,000,000 plus earnings subsequent to August 2, 1969.
>
> (d) . . . Further, the indenture has certain restrictive covenants but they are less restrictive than those contained in the note agreement with the three banks. (Emphasis added.)

The word "common" in paragraph (c) referring to the loan agreement was wrong because the relevant provision of the loan agreement restricted the use of retained earnings for

the payment of dividends on "*capital* stock of any class," not just "common." Thus the restriction on retained earnings would apply to all distributions to pay dividends or redeem the preferred shares issued to Standard stockholders should they approve the merger.

### D. Facts Respecting Peat's Negligence

The facts demonstrate that Peat's omissions were the result of negligence but did not arise from an intent to deceive, or *scienter*, as found by the District Court.

Peat failed to disclose fully in the financial statement the restrictive effect of the loan agreement and indenture on Chadbourn preferred stock. After each entry relating to long-term capitalization, the financial statement directs the attention of the reader to explanatory note 7. Note 7 alone pertains to Chadbourn's long-term debt. Missing from the note is any reference to limitations that the debt agreements placed on Chadbourn preferred stock.

Only in notes 7(c) and 7(d) does Peat mention the restrictive provisions. Note 7(c), which discusses the loan agreement, reports only that "the Company has agreed to various restrictive provisions including . . . the payment of dividends on common stock in excess of $2 million plus earnings subsequent to August 2, 1969." Note 7(d) describes the indenture. It says that "the indenture has certain restrictive covenants, but they are less restrictive than those contained in the [loan] agreement." Thus, there is no indication in either note that the long-term debt restrictions affected the redemption and earnings of preferred stock.

From notes 7(c) and 7(d), a reader easily could derive the following mistaken impression: The loan agreement contains certain restrictions on the payment of dividends by Chadbourn. As note 7(c) explicitly says, the loan agreement restrictions relate to the payment of dividends "on common stock." The indenture contains limitations that are "less re-

strictive" than those created by the loan agreement. Since the limitations of the loan agreement apply only to common stock, the reader mistakenly could reason that the "less restrictive" indenture constraints appear to have no broader sweep. What note 7 conveys to the reader is the erroneous notion that neither the loan agreement nor the indenture restrictions apply to Chadbourn preferred stock.

The remainder of the proxy solicitation does not entirely correct the misunderstanding created by the financial statement notes. Peat argues that the textual language from the body of the proxy statement, quoted above in subsection C, adequately advised Standard shareholders that long-term debt agreements restricted certain aspects of Chadbourn's preferred stock. We conclude, however, that contrary to Peat's claim, the text is equivocal.

The text states that Chadbourn cannot "declare any dividends" or "make any distributions" under certain conditions specified by the loan agreement. These phrases are placed under the heading "The Chadbourn Common Stock." It would not be irrational to conclude from the location of these statements that the restrictions applied solely to the common stock of Chadbourn. This conclusion would be confirmed by note 7(c), which explicitly states that the loan agreement restricts the payment of dividends on common stock. Moreover, under the section of the text labelled "Provisions Relating to the $.46-2/3 Preferred Stock," there is no indication that any debt restrictions exist, much less that they apply to the dividends or redemption of preferred stock.

Nor does the language in the text regarding indenture restrictions correct the misleading impression of note 7(d). The text reports that the indenture contains "certain restrictions on the payment of dividends on capital stock." Like note 7(d), the text fails to mention restrictions on the redemption of Chadbourn preferred stock. The language regarding dividend payment restrictions on capital stock is found in the "Chadbourn Common Stock" section. Its location casts

doubt on the argument that "capital stock," the restrictions on which are mentioned in part by the text, was meant in this context to include preferred stock. Adding to the doubt is the absence of any information about the indenture from the "Preferred Stock" section of the text. At best the textual discussion of indenture restrictions is equivocal regarding their reach.

The finding of the District Court that Peat acted with scienter in making the omissions is nevertheless clearly erroneous. We find in the record nothing to indicate that a desire to deceive, defraud or manipulate motivated Peat to omit from the financial statement information regarding the applicability of long-term debt restrictions. Indeed, Stanwood Corporation, the successor to Chadbourn controlled by the former Standard shareholders, hired and retained as vice president and treasurer the Peat associate, Hugh Freeze, who the shareholders' counsel now claim sought to defraud them. If the shareholders and their representatives really believed Freeze intended to defraud them, it seems doubtful that they would have put him in charge of the financial affairs of the corporation.

At most the evidence supports a finding that Peat acted negligently in preparing the financial statements. Peat became aware that note 7 incorrectly described the debt limitation several weeks before the merger vote occurred. The Standard proxy statement was mailed to its stockholders on March 27, 1970. Between March 23, 1970, and April 1, 1970, Chadbourn's outside counsel telephoned Freeze, the Peat manager in charge of the Chadbourn audit, and told him that a description of restrictions relating to Chadbourn's stock had been inserted in the forepart of the Standard proxy statement prior to mailing. The lawyer called to his attention the difference in the description in the proxy statement and the footnote, pointing out that the footnote said "common" rather than "capital stock of any class." In the course of this conversation, Freeze took a copy of the preliminary Standard

proxy statement and noted the change by hand in note 7(c). Thereafter, footnote 7(c) was not amended, and no effort was made to call the discrepancy to the attention of Standard stockholders or officials. Freeze did not foresee that the bottom would drop out of Chadbourn's earnings and that what appeared to be a minor error at the time would become a major bone of contention.

The evidence simply suggests a mistake, an oversight, the failure to foresee a problem. We find nothing in the record indicating an intent to deceive or a motive for deception. J. B. Woolsey, Standard's vice president for financial affairs, and presumably other Standard officers, knew of the restrictions and recommended the merger anyway. No stockholder testified that he was deceived. An erroneous statement cannot *ipso facto* prove fraud, and here we find no evidence of anything other than a negligent error.

## II. LIABILITY FOR NEGLIGENT MISREPRESENTATION UNDER SEC RULES 10b-5 and 14a-9

In view of our conclusion that the District Court's findings of scienter are clearly erroneous, we reverse the imposition of liability under Rule 10b-5. In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the Supreme Court settled the issue. It unequivocably held that liability under Rule 10b-5 requires "intentional misconduct." *Id.* at 201. The Court said that 10b-5 requires "intentional or willful conduct designed to deceive or defraud investors." *Id.* at 199.

We turn to the question of the standard of liability under Rule 14a-9 pertaining to statements made in proxy solicitations. There has been relatively little case law on the standard of liability following the Supreme Court decision in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), which established a private right of action under 14(a) and Rule 14a-9. Two circuits have examined the issue. Both have prescribed a negligence standard for the corporation issuing the proxy statement. One

held that the negligence standard also applies to outside, nonmanagement directors, *Gould* v. *American-Hawaiian Steamship Co.*, 535 F.2d 761, 777-78 (3d Cir. 1976); and the other intimated in dicta, without deciding the issue, that a *scienter* standard probably should apply to outside directors and accountants, *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300-1301 (2d Cir. 1973).

In view of the overall structure and collective legislative histories of the securities laws, as well as important policy considerations, we conclude that scienter should be an element of liability in private suits under the proxy provisions as they apply to outside accountants.

It is not simply a question of statutory interpretation. Federal courts created the private right of action under section 14, and they have a special responsibility to consider the consequences of their rulings and to mold liability fairly to reflect the circumstances of the parties. Although we are not called on in this case to decide the standard of liability of the corporate issuer of proxy material, we are influenced by the fact that the accountant here, unlike the corporate issuer, does not directly benefit from the proxy vote and is not in privity with the stockholder. Unlike the corporate issuer, the preparation of financial statements to be appended to proxies and other reports is the daily fare of accountants, and the accountant's potential liability for relatively minor mistakes would be enormous under a negligence standard. In contrast to section 12(2) of the 1933 Act which imposes liability for negligent misrepresentation in a prospectus, Rule 14a-9 does not require privity. In contrast to section 11 of the 1933 Act which imposes liability for negligent misrepresentation in registration statements, Rule 14a-9 does not require proof of actual investor reliance on the misrepresentation. Rule 14a-9, like 10b-5, substitutes the less exacting standard of materiality for reliance, *TSC Ind., Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), and in the instant case there was no proof of investor reliance on the notes to the financial

statements which erroneously described the restriction on payment of dividends. We can see no reason for a different standard of liability for accountants under the proxy provisions than under 10(b).[6]

We may not end our consideration there, however. We must turn to the legislative history of the proxy provisions. Section 14(a) and Rule 14a-9 are silent regarding the proper standard of liability. The Senate Report to the 1934 Act, commonly known as the Fletcher Report, discussed the sort of proxy abuse that Congress was trying to stop, that of corporate officers using the proxy mechanism to ratify their own frauds upon the shareholders, or outsiders soliciting shareholders' approval to plunder a ripe company. The Report cited one example, quoted below in the footnote.[7] The nature of each wrong deed depicted by the Report evidenced scienter.

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[6] Indeed section 18 of the 1934 Act, dealing with misstatements in reports filed with the SEC, requires *both* scienter *and* reliance for civil liability. Section 14 is much more similar to section 18 than it is to section 11 of the 1933 Act. Under the current regulatory scheme, proxy materials must be filed in advance of the solicitation with the SEC, *see* 17 C.F.R. § 240.14a-6, and are therefore subject to the provisions of section 18. In contrast, proxy solicitations *per se* do not put the solicitor within the ambit of section 11.

The District Court found that the plaintiffs could not recover under section 18 because they had not shown the reliance which is required by that section. This was, of course, true. At the same time, the defendants argue that the specific remedy provided by section 18 precludes implication of a cause of action under either section 10 or section 14, when the requirements of section 18 are not met. Only one circuit has directly discussed this question, finding that inability to satisfy the requirements of section 18 does not bar a less restrictive implied action brought under section 10, *Ross* v. *A. H. Robins Co., Inc.*, 607 F.2d 545 (2d Cir. 1979). This question was not specifically addressed by the District Court and, because we find that in all events, the plaintiffs cannot recover under sections 10 or 14, we need not decide this question here.

[7]

> The special meeting was called ostensibly to have the stockholders ratify the issuance of the shares of common stock used in connection with the Maister Laboratories, Inc., and Noxon, Inc., deal and the shares offered directly to stockholders.
>
> The letter to the stockholders failed to disclose the action of the board of directors authorizing the underwriting of the shares of capital stock offered to the stockholders; failed to disclose the secret interest of the chairman of the board and other

An even more informative section of the Report is one describing the scope of 14(a):

> It is contemplated that the rules and regulations promulgated by the Commission will protect investors from *promiscuous* solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by *unscrupulous* corporate officials seeking to retain control of the management by *concealing* and *distorting* facts. (emphasis added)
>
> Senate Committee on Banking & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. 77 (1934).

The words "unscrupulous," "concealing," and "distorting" all imply knowledge or scienter; and we interpret "promiscuous" to mean reckless. In addition the characterization of irresponsible outsiders trying to "wrest control . . . from *honest* . . . corporate officials," implies dishonesty – and hence scienter – on the part of the outsiders. Consequently, the Report leads us to believe that its authors contemplated that 14(a) would be applied only against the knowing or reckless wrongdoing of outsiders.

The few times the proxy section was discussed in debate paint a similar picture of the type of misconduct against which

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officers and directors of the corporation in the underwriting agreement; failed to disclose the actual assets or the value of the assets of the Maister Laboratories, Inc., or Noxon, Inc.; failed to disclose that the Maister Laboratories, Inc., and Noxon, Inc., were organized by two dummies of the president of the board; failed to disclose the existence of an option to Thomas E. Bragg for 25,000 shares of capital stock of the corporation at $18 per share; and failed to disclose that the president of the board and other officers and directors of the corporation were secret participants in a pool organized to operate under that option. The letter to the stockholders and the proxy requested the stockholders to ratify the acts of the very officers and directors who were betraying them by participating secretly in the underwriting agreement and pool operation, from which they obtained substantial profits. (footnotes omitted) Senate Committee on Banking & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. 75 (1934).

14(a) was directed. Roosevelt's aide, Corcoran, who drafted the original version of the 1934 Act, spoke of "*unscrupulous* proxy committes" (emphasis added). *See* 78 Cong. Rec. 6544 (1934). Everett Dirksen, then a Representative from Illinois, stated, "[t]here is little doubt that there has been grave abuse of this authority to solicit proxies and the use of such proxies for *manipulation*" (emphasis added) 78 Cong. Rec. 7961 (1934). Further debate indicates Congress' concern that directors and officers should not be able to complete their fraud upon a company by means of a proxy solicitation that seeks ratification of their illegal acts. *See* 78 Cong. Rec. 7712-14 (1934). Congressman Pettengill of Indiana stated during Committee hearings exactly what he thought such undesirable activity amounted to: "larceny." *See Hearings on H.R. 7852 Before the House Comm. on Interstate & Foreign Commerce*, 73d Cong., 2d Sess. 480 (1934). The common denominator of all these depictions of the problem is wrongdoing with some degree of knowledge, *i.e.* scienter; and nowhere, not in the committee reports nor in the House or Senate debates, does it appear that Congress desired to protect the investor against negligence of accountants as well.

Another important consideration is Congressional intent regarding subsequent amendments that are indirectly linked to 14(a). In passing the Williams Act of 1968[8] governing tender offers, Congress expressed the desire that proxy statements and tender offers be governed by the *same* rules and regulations. This would logically extend to standards of liability. Because 14(e)[9] pertaining to tender offers requires scienter,

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[8] Pub. L. No. 90-439; 82 Stat. 454 (1968).

[9] 15 U.S.C. § 78n(e) (1976): *Untrue statement of material fact with respect to tender offer*:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender, offer or re-

we believe there is a strong policy reason for imposing a similar standard on 14(a).

According to the House Report for the Williams Act, "[t]he cash tender offer is similar to a proxy contest, and the committee could find no reason to continue the present gap in the federal securities laws which leaves the cash tender offer exempt from disclosure provisions." H. R. Rep. No. 1711, 90th Cong., 2d Sess., *reprinted in* [1968] U.S. Code Cong. & Ad. News 2811, 2813. Tender offers and proxy solicitations are two alternative methods of achieving the same result, corporate control; and Congress perceived that both were subject to the same type of abuse. It therefore acted to eliminate an existing loophole in the old law so that wrongful usurpation of control would not escape securities regulation whenever one combatant chooses to seize control by tender offer rather than by proxy fight. *Id.*

Senator Williams of New Jersey, the sponsor of the bill, stated

> What this bill would do is to provide the *same kind of disclosure requirements which now exist*, for example, *in contests through proxies* for controlling ownership in a company." (emphasis added)

113 Cong. Rec. 24665 (1967).

Senator Javits echoed this view.

> The Senator [Williams] represents to the Senate, and I accept his representation fully, that this is analogous to the proxy rules. *Id.*

And Senator Williams repeated that "[t]his legislation is patterned on the present law and regulations which govern

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quest or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.

proxy contests." *Id.* Logically the above testimony implies similar standards of liability for both proxy statements and tender offers. Otherwise some misleading solicitations which would trigger liability if shaped in the form of one transaction, would be immune if shaped as the other, or *vice versa.*

The language of the Williams Act clearly demonstrates that Congress envisioned scienter to be an element of 14(e). Congress used the words "fraudulent," "deceptive," and "manipulative." This language indicates, in light of *Ernst & Ernst*, that 14(e) requires scienter. Although *Ernst & Ernst* was decided several years after the enactment of 14(e), we are bound by its holding that Congress intends scienter when it uses the above quoted language.

We conclude that 14(a) and 14(e) should be governed by the same standard of liability insofar as accountants' liability is concerned, and that an action under 14(a) requires proof of scienter. Finding no evidence of scienter, we reverse the imposition of liability under 14(a) and Rule 14a-9.

## III. COMPUTER DEFECTS

Chadbourn used electronic data processing to record many of its financial records from sales to inventory on hand. The District Court found various deficiencies connected with these computer accounts which, it concluded, Peat should have disclosed in the notes accompanying the proxy statement.

The record contains evidence of poorly documented computer programs, a high level of computer personnel turnover, lack of security in the computer room, erroneously coded data, and poorly designed computer programs that failed to detect improperly coded data. Peat sent several memoranda to Chadbourn's management, documenting the computer weaknesses; and one internal Chadbourn memorandum not written by Peat, stated that the company was "pushed . . . to the brink of bankruptcy" by the unreliability of computer-gener-

ated information. The District Court found that Peat's failure to disclose these weaknesses constituted fraud. We disagree.

An outside accountant examines the quality of a company's internal accounting primarily to determine the extent to which he must test a client's records. The more reliable the client's accounting system proves to be, the less testing the accountant must conduct. A by-product of this testing is the discovery of weaknesses in internal accounting. The accountant may bring such weaknesses to the attention of management but he is not always obligated to inform the stockholders. This is not to say that an accountant may keep a blind eye to all wrongdoing while walking through a client's corporate headquarters. He may be held liable to the extent that he intentionally or recklessly disregards the generally accepted, standard body of accounting knowledge. This is not the case here. Although we cannot say the District Court's inference, that faulty computer information materially impaired management's ability to manage, is clearly erroneous, there was no scienter in Peat's failure to disclose. The absence of an intent to deceive is fatal to plaintiff's claim.

According to the Statements on Auditing Procedure,[10] promulgated by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA), the accountant may have a duty to direct management's attention to internal accounting weaknesses he has uncovered. But the Committee imposed no requirement that the notes to the certification of financial reports contain a similar disclosure of such weaknesses.

An auditor cannot always make an assessment of the effect of accounting weaknesses on the efficiency of a company. Often such an assessment requires a technical knowledge of

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[10] *See* AICPA, STATEMENT ON AUDITING PROCEDURE, No. 33 at 32 (1963); AICPA, STATEMENT ON ACCOUNTING STANDARDS No. 1 §§ 320, 640 (1973); Carmichael, *Opinions on Internal Control*, JOURNAL OF ACCOUNTANCY 47 (1970). The AICPA in 1977 promulgated a rule that disclosure to management was required. *See* AICPA, STATEMENT ON ACCOUNTING STANDARDS No. 20 (1977).

a business in which accountants have no expertise. Peat's reliance on the AICPA's committee opinions is sufficient indication of good faith and lack of scienter.

Peat cannot be charged with knowledge of the interplay between poor or inefficient record-keeping procedures and mismanagement. Nor does the record disclose that Peat actually knew of Chadbourn's internal memoranda evaluating the effect of poor computer information upon management. Likewise, the evidence does not support a finding of recklessness.

Finally, undisputed testimony shows that by the time of the proxy solicitations, many of the computer problems had already been solved. The only relevant disclosure would have been that, for the two quarters preceding the merger, Chadbourn's management may not have been sufficiently informed due to temporary computer deficiencies. Accountants are not liable for failing to speculate publicly about this subject.

## IV. THE AUDIT

The District Judge also held that Peat failed to conduct its audit according to generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS), and therefore fraudulently misrepresented material facts about Chadbourn by certifying the proxy financial statements. The Court found deficiencies in two important areas of the audit, the closing inventory and accounts receivable. We conclude that there is sufficient evidence to support the Court's finding that Peat inadequately tested Chadbourn's financial figures in certain respects, but the evidence falls far short of proving that Peat intended to deceive the stockholders or that its negligence produced financial statements *materially* at odds with the real facts. The question of materiality in this context is whether, given all the financial information, there was a substantial risk that the actual value of assets or profits were significantly less than Peat stated them to be.

The District Judge found errors in five aspects of the inventory valuation: the physical count, the standard cost audit, the conversion from standard to actual costs, the inventory "work forward," and the "lower of cost or market" test. An accurate appraisal of inventory is important in a business such as Chadbourn's because, aside from exaggerating the primary asset listed on the balance sheet, overvaluing the closing inventory lowers the annual cost of sales and thus inflates net earnings.[11] This latter figure is especially sensitive to fluctuation in inventory value when inventory value is disproportionately greater.

**1. Physical Count**

In conducting a physical inventory, independent accountants do not count every item on their client's premises. The client's employees count inventory items, and usually these counts are documented on accounting forms or "tickets" as to style, quantity, as well as other relevant characteristics. The accountant's responsibility is to conduct statistical tests on a cross-section of these accounting tickets to determine whether the client counts were correct. The client counts need not exactly coincide with the accountant's spot check count, as long as the percentage of discrepancies to total number of goods, is small.

The District Court found that Peat conducted inadequate tests for counts of both finished stockings and greige goods.[12] The finding regarding greige goods is based on testimony by witness Rittenberg that from a total of 1000 to 1500 bins of goods, a Peat employee tested about 100, and that the

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[11] Costs of sales = value of starting inventory + production costs incurred during fiscal year − value of closing inventory. *See* W. CONKLING & P. PACTER, ATTORNEY'S HANDBOOK OF ACCOUNTING 5-29 (H. Sellin 2d ed. 1971).

Net earnings = Gross sales − cost of sales.

[12] Greige goods are unfinished, unshaped stockings.

Peat count on items inside each bin conflicted with Chadbourn's in 40 to 50 of the bins tested. In examining the exhibit from which Rittenberg drew his conclusion, we calculate for the bins tested that the average variance between Peat's and Chadbourn's count, weighted by the total number of goods, was only about four percent. The greige good inventory, as a whole, was valued at $2 million. This degree of variance in the greige good account is insufficient to render the inventory figure a material misstatement of fact.

The District Judge's finding regarding the count of finished goods was based on cross examination testimony of Peat's accountant, William Brasington. After selecting four work papers, Brasington stated that, for one ticket listing representing 199,000 dozen, one style consisting of 1655 dozen was tested and a difference of 28 dozen was found. He "admitted" that this test by itself would have been insufficient but claimed that other testing was done. He also testified that in another instance, a count of 435,000 dozen was not tested at all. It is not a reasonable conclusion, however, that the total amount of testing was insufficient.

Brasington vigorously insisted that on the whole testing was adequate. The Record does not indicate the total number of discrepancies found in either Brasington's four work papers or all the work papers combined. Nor does it indicate for what purpose Brasington was asked to select these four work papers. No expert witness claimed that the testing of the physical count was insufficient. Plaintiff's chief witness concerning the audit, Larry Rittenberg, examined Peat's work papers and testified in lengthy detail to the errors and omissions in Peat's work. He did not testify that there were any errors in the physical count.

The District Judge inferred from the counts of the two inventory items that were not fully tested, and from Brasington's failure to produce other work papers, that all the work papers relating to the physical count were deficient. But

the record does not show that the four work papers were deficient on the whole.

The four papers were only a part of the testing of the total count. In order to determine whether the testing was deficient there must be evidence from a large enough sample of work papers from which a statistically valid conclusion about the whole may be drawn. The evidence does not support a conclusion that there was a material miscount in these inventory items.

Third, the District Judge found that Peat did not adequately test a computer listing of finished goods that was compiled from the accounting tickets. The testimony cited by the District Court was again taken from the cross examination of Brasington. Brasington said that five percent of the listings were tested and that 1 to 2 percent error was found. The District Court evidently interpreted the witness to mean that of the five percent tested, 1/5 to 2/5 of the listings were wrong. What the witness clearly meant, however, was that 1 to 2 percent of the sample tested were inaccurate, and interpolating this 5 percent sample to the whole, that 1 to 2 percent of the entire listing might have been inaccurate. This small error is immaterial and supports the validity of Peat's testing.

The District Judge also found that Peat conducted insufficient cut-off tests. A cut-off test is one designed to tag inventory at the plant at which it was first counted so that it is not counted twice if shipped to another plant. The record does not indicate, however, that this affected a material portion of goods.

**2. Standard Cost Audit**

Next plaintiffs contend that Peat did not test Chadbourn's "build-up" of standard costs. A build-up of standard costs involves an estimate of costs per unit of goods; it starts with production records or engineering studies on the costs

of labor and raw materials per good. The costs are totalled and checked style by style for consistency. The "build-up" represents what it should cost to produce goods under realistic day to day manufacturing circumstances barring unusual, unforeseen, and evanescent occurrences. Determining standard cost is a method of allocating total actual costs among different styles, and is an intermediate step in valuing the actual cost of the closing inventory.

The District Court found that Peat's testing of the standard cost build-up was not documented in its workpapers, and concluded that Peat never audited the standard cost at all. Plaintiffs have not proved, however, that there was a material risk that a proper audit of the standard cost system would have revealed materially lower costs. Indeed, the evidence tends to support Peat's valuation. Actual costs were extremely close – and slightly higher – than the estimated standard cost, a prima facie indication of a relatively small risk that standard costs were materially lower. Nor does the record indicate unusual circumstances that unduly inflated actual production costs.

In the unlikely event that standard costs for some styles were materially lower, standard costs for other items must have been higher in order for the sum of standard costs to have approached the actual cost so closely.[13] And in order for this mix of under and overvalued standard costs to have effected a material change in the valuation of the closing inventory, plaintiff must show that disproportionately more "overvalued" cost items than "undervalued" cost items were not sold and remained in the closing inventory. Consequently, even assuming Peat did not conduct further testing than the work papers directly indicate, this omission was immaterial. Moreover, there is a total absence of evidence of fraudulent intent.

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[13] Again this assumes no exceptional production costs. No such exceptions are documented in the record.

**3. Conversion of Standard to Actual Costs**

A third complaint is that Peat knowingly failed to establish standard cost centers for each plant, from which standard costs would be converted to actual costs on a plantwide basis. Instead, Peat computed a weighted average variance between what it perceived to be the actual-to-standard variances for each plant, and then used one company-wide average variance to convert each good's standard cost to its actual cost. The District Judge found on the basis of Rittenberg's testimony that this procedure violated both GAAS and GAAP. Whether or not this finding was clearly erroneous, plaintiff's chief witness specifically refused to conclude that there was a material risk that Peat's calculations thereby inflated the value of the closing inventory.

A plantwide "standard-to-actual" variance would be computed and utilized in valuing the entire company's inventory, only if there were an overall write-down from actual cost to market value in at least one plant. In order for Peat's method of calculation to result in an inflated valuation, plaintiffs must prove (1) that there had been an overwhelming concentration of goods whose actual cost exceeded market value in plants which had above average actual-to-standard variances, and (2) that there was no overall concentration of such goods in the other plants. There is no evidence that such circumstances occurred, and again, the information on which Rittenberg based his opinions could not have provided an adequate foundation for finding a material risk.

**4. Inventory Work Forward**

Peat observed the inventory approximately four weeks prior to the end of Chadbourn's fiscal year. Peat updated the inventory to its status as of the fiscal year's end, using computer-generated data on sales transacted (the "gross profit report") subsequent to the taking of the physical inventory. The District Judge found that Peat's reliance on Chadbourn's com-

puter system — with all its weaknesses — constituted a departure from GAAS, and therefore made its certification a material misrepresentation.

Of the long list of deficiencies the most relevant one was that "approximately 25% of customer service source documents [were] incorrectly coded." Testimony by Dalton, the head of Chadbourn's computer operations, indicates that a significant portion of the incorrect coding was of style number. This same style coding was used by the "gross profit report" program to retrieve individual costs for each item sold. This cost information was in turn used by Peat in its inventory work forward. If styles were incorrectly coded, this program which matched up styles with their respective costs would have been unable, by itself, to register the transaction correctly. But we cannot determine whether it would necessarily have provided an erroneous cost.

The District Judge found that Peat did not test the sales data for the work forward; this finding is not clearly erroneous. There is hearsay testimony that Peat conducted such tests in September or October of 1968, several months before the memo documenting the 25% error rate in coding. The District Judge evidently inferred from Peat's failure to document such testing in its workpapers, that the testing did not occur. The record also establishes adequate foundation for this inference.

Without examining the computer program documentation and procedures used by Chadbourn's computer operators for erroneously coded data, or conducting a test of the gross profit report data, Peat did not have any basis to evaluate the risk involved in using the reports. Although witness Rittenberg had no foundation to evaluate and testify on the risks either, we believe it is true that Peat conducted no testing on reports which dealt with $2 million in sales costs. The distinction here is between inadequate testing and no testing at all. The risk that twenty-five percent of styles were

incorrectly coded presented the risk that the costs of twenty-five percent of the month's cost transactions totaling $2 million were incorrectly stated. Although the failure here could lead to a material error, there is no evidence that it did and certainly no evidence of scienter.

**5. "Lower of Cost or Market" Test**

The final step in valuing a physical inventory is the markdown of items whose actual cost exceeds market value. The auditor must test a sampling of sales to determine whether its client has provided adequate reserves — and hence an adequate markdown in inventory value — for goods that are selling below cost. This is done in order to realize losses in inventory value as soon as they occur.

The District Judge found that Peat examined an insufficient number of sales to test Chadbourn's reserves. This is supported by Rittenberg's testimony. However, Brasington, one of Peat's accountants, gave uncontradicted testimony that the valuations proved to be correct from subsequent market studies on individual styles. Subsequent valuations would not have been so close to Peat's original predictions for *so many different styles*, had Peat's testing been materially inadequate. The District Judge's finding here is clearly erroneous.

**6. Accounts Receivable**

Finally, the District Judge found that Peat failed to "reconcile" confirmations taken at different dates of Chadbourn's accounts receivable. A confirmation of an account receivable is simply a test of whether as of a certain date a customer of Chadbourn actually owes what Chadbourn's records show them to owe. Peat claims that the confirmation tests were adequate because it all, over 80% of accounts were tested. But Peat misunderstands the thrust of the Court's finding. When an accountant does not "reconcile" tests conducted on different dates, this leaves open the possibility that a customer

who apparently is acknowledging an old debt, may actually be acknowledging a new one acquired between the two test periods. All confirmations must be confirmations of debts incurred as of a specific date.

The District Judge's finding that these tests were not reconciled is not clearly erroneous. Accounts receivable was listed as approximately $10 million or 15% of total assets of $65 million, and is therefore a material asset. The record, however, is silent on the magnitude of error that could have resulted from conducting confirmation tests on different but relatively close dates. It is improbable — and there is no evidence — that customers' debts increased so radically over a one month period to have materially altered Chadbourn's total accounts receivable. Consequently, plaintiffs have not shown Peat's failure to reconcile dates to have been material.

Accordingly, the judgment of the District Court is reversed.

WEICK, Circuit Judge, dissenting.

The complaint in this case was filed on October 12, 1972, in the United States District Court for the Eastern District of Tennessee, Northern Division at Knoxville.

Honorable Robert L. Taylor, who had been serving with distinction as a judge of the court for many years since his appointment to the bench on March 9, 1950, recused himself. Chief Justice Burger designated Honorable George Boldt, Senior District Judge of the Western District of Washington to serve in the place of Judge Taylor and to preside over this case. Judge Boldt accepted the designation. Judge Boldt, like Judge Taylor, had served with distinction since his appointment to the federal bench on July 27, 1953. He became Chief Judge on March 1, 1971 and Senior Judge on October 30, 1971. While engaged in the practice of law, he served as Assistant Attorney General of the State of Washington 1940-41 and 1946-1947. He was a Lieutenant Colonel in the United States Army, 1942-1945. He served as Chairman of the Pay Board, United States Economic Stabilization Program, 1971-1973. He served on the Judicial Conference Committee on Criminal Law, 1955-1965; the Coordinating Committee on Multi-District Litigation 1962-1970; the Committee on Multi-District Litigation, 1962-1972; the Committee on Rules of Procedure and Practice, 1960-1972; the Advisory Committee on Appellate Rules since 1973. It would appear that Judge Boldt, because of his vast experience as a trial judge and public service, was eminently well-qualified to try this case and certainly was not a novice. His qualifications are mentioned particularly because, in my opinion, the majority has usurped the fact finding functions of Judge Boldt, who did not deserve that treatment. It was not the province of an appellate court to review the factual findings of a trial judge *de novo* which is exactly what the mapority did in the present case in many instances by stating that they were clearly erroneous when indeed they were not

clearly erroneous, but were supported by substantial evidence, the testimony of many witnesses, including expert witnesses, depositions and credibility assessments made by the judge.

The majority obviously did not follow the standards mandated by the Supreme Court in *Zenith Corporation* v. *Hazeltine*, 395 U.S. 100, 123 (1969), where the court in an opinion written by Mr. Justice White stated:

> In applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues *de novo*. The authority of an appellate court, when reviewing the findings of a judge as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence. The question for the appellate court under Rule 52(a) is not whether it would have made the findings the trial court did, but whether "on the entire evidence [it] is left with the definite and firm conviction that a mistake has been committed." *United States* v. *United States Gypsum* Co., 333 U.S. 364, 395 (1948). See also *United States* v. *National Assn. of Real Estate Boards*, 339 U.S. 485, 495-496 (1950); *Commissioner* v. *Duberstein*, 363 U.S. 278, 289-291 (1960).
>
> Trial and appellate courts alike must also observe the practical limits of the burden of proof which may be demanded of a treble-damage plaintiff who seeks recovery for injuries from a partial or total exclusion from a market; damage issues in these cases are rarely susceptible of the kind of concrete, detailed proof of injury which is available in other contexts. The Court has repeatedly held that in the absence of more precise proof, the factfinder may "conclude as a matter of just and reasonable inference from the proof of defendants' wrongful acts and their tendency to injure plaintiffs' business, and from the evidence of the decline in prices,

> profits and values, not shown to be attributable to other causes, that defendants' wrongful acts had caused damage to the plaintiffs." *Bigelow* v. *RKO Pictures, Inc., supra,* at 264. See also *Eastman Kodak Co.* v. *Southern Photo Materials Co.,* 273 U.S. 359, 377-379 (1927); *Story Parchment Co.* v. *Paterson Parchment Paper Co.,* 282 U.S. 555, 561, 566 (1931).

See also *Strickler* v. *Pfister Associated Growers, Inc.,* 319 F. 2d 788, 790 (6th Cir. 1963).

As will be pointed out later, this decision is not the only decision of the Supreme Court which a majority of this panel did not follow.

The District Court, after an extensive trial, following discovery and many proceedings in this complex case, filed its "Memorandum Decision" and also "Findings of Fact and Conclusions of Law." It specifically found that Peat had prepared a proxy statement which contained false and misleading financial statements which proxy statement was to be used in connection with the acquisition of Standard Knitting Mills, Inc. (Standard) a Tennessee corporation, by Chadbourn, Inc., (Chadbourn) a North Carolina corporation, to induce the shareholders of Standard to vote in favor of said merger and to be filed with the SEC.

The Court found that Peat had acted "willfully, with intent to 'deceive' and 'manipulate' and 'in reckless disregard of the truth.'" The Court further found that Peat's certificate of an audit of Chadbourn was false and untrue. Because of these findings the Court determined that Peat had violated the Act and said Rules of the Commission.

Peat has appealed to this Court, filing a brief in chief containing 124 pages and a reply brief containing 54 pages, both briefs raising a myriad of questions. A brief of 122 pages was filed by the plaintiff's class, and briefs by sub-class and intervenors were filed and an amicus brief by American Institute of Certified Public Accountants was filed. In addition, eight large volumes of joint appendices have been

filed containing various proceedings, transcripts of evidence at the trial, depositions and exhibits.

In this appeal, as before stated, it was not our function to conduct a de novo hearing. In an action involving claims of fraud, securities violations, and reckless conduct where the testimony at a bench trial was taken before an experienced District Judge who had the opportunity to and did take testimony of witnesses, observe the demeanor of the witnesses and to make credibility assessments, we are not permitted to set aside his factual findings unless we are satisfied and can demonstrate that they are not supported by substantial evidence and are clearly erroneous. *Fed. R. Civ. P.* 52(a). The majority was unable to demonstrate that the District Judge did not have sufficient evidence to support his findings of intentional fraud or reckless conduct.

In my opinion, the findings of fact adopted by the District Court are supported by substantial evidence and are not clearly erroneous. I would affirm the judgment of the District Court for the reasons herein set forth.

## I.

In 1969 Chadbourn, a moderately sized Charlotte, North Carolina manufacturer of hosiery and panty hose, enjoyed substantial sales due to the popularity of panty hose, its major product. Between 1967 and 1969 Chadbourn's earnings had increased many times. For the year ending August 2, 1969, it had sales of $68,074,688 and its 3,800,000 shares were listed on the New York Stock Exchange. During this period the market for panty hose was free of foreign competition and price cutting. In the late 60's Chadbourn embarked upon an aggressive acquisition campaign.

In 1968 and in early 1969 Chadbourn became interested in acquiring Standard Knitting Mills of Knoxville, Tennessee. Standard was a relatively small company whose shares of stock were owned and controlled by Knoxville residents. Its

632,000 shares of common stock were registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and were publicly held by 556 persons and were seldom traded. The sales price of the few shares that did change hands was roughly at $11 a share. Twenty-two percent of its stock was held and controlled by Valley Fidelity Bank and Trust Company of Knoxville in a number of fiduciary accounts. Nineteen percent was held or controlled by officers and directors of Standard and their families. The officers and directors of Standard were considered to be substantial people in Knoxville. Although many of its plants were old, it had for many years run a sound business and paid dividends by manufacturing cotton knitwear. In the late 60's three large chain store customers bought approximately 50 percent of its output.

Prior to the merger and during the period of negotiation for the shares of Standard, Chadbourn offered for sale to its shareholders and to the public $12,631,000 of 6½ percent 20 year convertible subordinated debentures due March 15, 1989 pursuant to an Indenture dated March 15, 1969.

On July 28, 1969, Chadbourn and Standard agreed to merge subject to a vote of approval by the Standard shareholders which vote eventually took place at a special meeting of its shareholders held on April 22, 1970. In return for each share of Standard stock Standard shareholders were to receive one and one half shares of Chadbourn $.46-2/3 Cumulative and Convertible Preferred Stock, Jr., Series A, created specifically for the purpose of consummating the Standard merger. In addition, Chadbourn specifically agreed to repurchase the preferred from shareholders of Standard who desired to sell at $11 per share in five yearly installments from 1975 to 1979.

As a result of the merger, Chadbourn acquired a relatively conservative textile manufacturing company that was well entrenched in the Knoxville community. For many years Standard had operated as a sound business enterprise, and

indeed, it reported its first operating loss in recent history in the months just prior to the merger with Chadbourn, and also reported earnings weakness for the period immediately after the merger. Three of its customers were large chain stores that were valuable clients. The $.46-2/3 dividend, $10 par cumulative convertible preferred financed the acquisition by Chadbourn without any immediate outlay of a large sum of money. Chadbourn thus obtained beneficial control of the company and its earning power. Further, Chadbourn did not need to resort to a bank or to the competitive money markets for financing the merger at a high rate of interest which allowed it to use any bank credit that was available to it for other purposes. Because of the relatively small dividend the most valuable feature of the preferred was its ability to be converted into .6 share of Chadbourn common which fluctuated in value between $8 and $14 per share before the merger. From the point of view of the plaintiff class and sub-class, former Standard common shareholders, the merger offered some advantages. In return for their common, plaintiffs were to receive cumulative preferred dividends larger than dividends declared historically on Standard common, each share of preferred was convertible into Chadbourn common, the preferred was readily marketable on the New York Stock Exchange for cash, a small amount of Chadbourn common would be distributed pro rata among holders of the preferred if Standard achieved certain earnings goals, and Chadbourn promised to redeem the preferred at $11 per share in installments from 1975 to 1979 to shareholders desiring redemption.

In September, 1969, approximately two months after the agreement to merge was signed but before it was approved by Standard's shareholders, Chadbourn borrowed six million dollars from North Carolina National Bank, First National Bank of Boston, and the First National Bank of Atlanta. The loan agreement called for twenty consecutive quarterly installment payments of $150,000 and a final lump sum pay-

ment of any remaining balance so that the entire loan would be retired on October 1, 1974, if the payments were made several months before Chadbourn agreed to begin redeeming the preferred stock.

An internal Peat memorandum acknowledged on July 24, 1969, the engagement of its services by Chadbourn in preparing a "[p]roxy statement to be filed [with the SEC] for stockholders of Standard Knitting Mills, Inc. in connection with the proposed acquisition of Standard and its subsidiaries by Chadbourn." It was also to be used to solicit votes of Standard shareholders favoring the proposed merger. Peat made the audit during the July 4th 1969 holiday as was customary in the textile industry. It was ultimately dated August 2, 1969.

Peat received $194,424 for its services from Chadbourn in 1969-70. Peat charged $105,000 for the audit and $26,000 for the Standard proxy work. Peat charged a fee that was 125% of its usual fee because "SEC work does require a higher degree of risk," however, Peat admits that it exercised no different degree of care in performing its services for Chadbourn.

The Standard proxy materials in issue were mailed to Standard shareholders on March 27, 1970. The merger was approved by the shareholders at a special meeting for that purpose held on April 22, 1970. At the meeting Mr. Kramer, General Counsel and a Director of Standard, represented that there were no restrictions on the payment of dividends on the $.46-2/3 cumulative and convertible preferred. This representation conformed to Footnote 7 of the Chadbourn financial statement contained in Standard proxy materials which was written and certified as correct by Peat. Footnote 7 in pertinent part reads as follows:

> (7) Long-Term Debt:
>
> (c) As to the note payable to three banks, the Company has agreed to various restrictive pro-

> visions including those relating to maintenance of minimum stockholders' equity and working capital, the purchase, sale or encumbering of fixed assets, incurrance of indebtedness, the leasing of additional assets and the payment of dividends on *common* stock in excess of $2,000,000 plus earnings subsequent to August 2, 1969.
>
> (d) The 6% debentures are . . .
>
> Further, the indenture has certain restrictive covenants but they are less restrictive than those contained in the note agreement with the three banks. [Emphasis ours]

The footnote incorrectly stated that the restriction upon the payment of dividends contained in the bank loan agreement applied only to Chadbourn common stock. Further, the exact provisions of the restrictive covenants of the Indenture are not set out but are characterized as "less restrictive than those contained in the note agreement with the three banks," implying that only restrictions on payment of dividends on common were contained in the Indenture. There is no mention of restrictions on the payment of dividends on Chadbourn preferred stock contained in the bank loan agreement or the Indenture, and there is no mention whatsoever of any restrictions on redemption of the preferred stock contained in either the bank loan agreement or the Indenture.

Approximately one month after the merger was approved plaintiffs received a proxy from Chadbourn soliciting their votes for approval of a loan and option agreement involving the acquisition of United Hosiery Mills by Chadbourn (the UHM proxy materials). Footnote 7(c) of the financial statement in the UHM proxy materials, which corresponded to footnote 7(c) contained in the Standard proxy materials, *supra*, had been altered so that the word "common" hereinbefore referred to was changed to the word "capital," thus indicating that restrictions on payment of dividends con-

tained in the bank loan agreement applied to both common and preferred stock. This change was not brought to the attention of the reader in Peat's certification of the Chadbourn financial statement contained in the UHM proxy materials and the change was located on the 55th page of 77 pages of the UHM proxy materials.

Several months after plaintiffs received the UHM proxy materials plaintiffs received the 1970 Chadbourn Annual Report, which contained a financial statement for Chadbourn prepared by Peat. Footnote 6(c) of this financial statement returned to the use of the word "common." A quick reference to the 1969 Chadbourn Annual Report for the purpose of resolving this ambiguity would reveal that the pertinent footnote in the 1969 Chadbourn Annual Report used the word "common" as well. Footnote 7(c) in the UHM materials, therefore, was the only footnote in the certified financial statements in issue received by plaintiffs which indicated that restrictions on the payment of dividends in the bank loan agreement and Indenture applied to both common stock and preferred stock. The 1969 Chadbourn Annual Report, the financial statement in the Standard proxy materials, and the 1970 Chadbourn Annual Report uniformly indicated that the restrictions on the payment of dividends applied to common stock only, and none of the financial statements in issue, including the one in the UHM proxy materials, mentioned any existence of restrictions upon redemption contained in the bank loan agreement and the Indenture.

The loan agreement and the Indenture in fact contained covenants which restricted the payment of dividends upon common and preferred stock and the redemption of common and preferred stock. The bank loan agreement in pertinent part provided that Chadbourn would not:

> 5.3. Declare or pay any dividend on its capital shares of any class or make any distribution to any shareholders as such (other than dividends or distributions payable solely in common stock of the Company and

other than cash paid in lieu of fractional shares in connection with any such dividend payable solely in common stock of the Company), or purchase, redeem or otherwise acquire for value any shares of its stock of any class, if, after giving effect to such action, the aggregate of:

(a) all dividends, other than in common stock of the Company, on its capital shares of all classes, preferred and common, and all other distributions to shareholders as such (other than cash paid in lieu of fractional shares in connection with any dividend payable solely in common stock of the Company) between August 2, 1969 and the time of taking such action; plus

(b) all amounts paid out for any redemptions, purchases or other acquisitions of its stock of any class (other than amounts for redemption of any shares of the Company's 6% Cumulative Preferred Stock, $50 par value) between August 2, 1969 and the time of taking such action; plus

(c) the amount of all payments required to be made, and of all prepayments made, on principal of the Note prior to the time of taking such action;

would exceed the sum of:

(y) $2,000,000; plus

(z) the consolidated net earnings (including special items) of the Company and its subsidiaries accumulated subsequent to August 2, 1969;

provided that any subsidiary may declare and pay dividends.

The pertinent text of the Indenture is less precise. The text in pertinent part reads as follows:

Section 5.05. The Company will not declare or pay any dividends or make any distribution on or with respect to its capital stock, except for dividends payable solely in capital stock of the Company and except for cash

paid in lieu of fractional shares in connection with any such dividend payable solely in capital stock of the Company, and will not permit any subsidiary to, directly or indirectly purchase, redeem, or otherwise acquire for a consideration any capital stock of the Company if the aggregate amount of all such payments or distributions after August 3, 1968 would exceed the sum of

(i) $2,000,000 plus

(ii) the net proceeds (exclusive of any underwriting discounts or commissions or other expenses paid or incurred by the Company in connection therewith) of the sale for cash by the Company of any shares of its capital stock after August 3, 1968 less the amount paid by the Company for the purchase with cash of any shares of its capital stock after August 3, 1968 plus

(iii) Consolidated Net Income realized after August 3, 1968.

Consolidated Net Income from August 3, 1968, to August 2, 1969, was $3.01 million. This language can be read to restrict redemption by Chadbourn subsidiaries only. Peat Marwick argues that the latter interpretation is correct and that Chadbourn itself was never under the terms of the Indenture restricted in its ability to redeem the preferred. There is evidence, however, that the Indenture was drawn with the intent to restrict redemption by Chadbourn. For example, Mr. Johnston, counsel for Chadbourn, disagreed with Peat on precisely this issue. He published a text in a note 8(d) of the financial statement contained in the 1971 Chadbourn Annual Report which indicated that the Indenture restrictions upon redemption also applied to Chadbourn. That footnote in pertinent part reads as follows:

(8) Long-Term Debt:

(d) The 6½% debentures are . . .

Further, the indenture contains a restrictive provision

> under which the Company cannot declare any dividends or make any distribution (other than capital stock dividends), or acquire any of its stock if, after such action, the aggregate of all dividends (other than stock dividends), other distributions to stockholders and all amounts paid for the acquisition of its stock would exceed the sum of (i) $2,000,000 plus (ii) the net proceeds of the sale for cash by the Company of any shares of its capital stock after August 3, 1968 plus (iii) consolidated net income realized after August 3, 1968.

This same text was published in the 1972 and 1973 Chadbourn Annual Reports. These restrictions in effect limited the amount available for future dividends and future redemptions by Chadbourn to $2 million plus post-1969 earnings under the bank loan agreement, and $5.1 million plus post-1969 earnings under the Indenture. The promised redemption of the preferred from 1975 to 1979 would cost roughly $10 million if all of the preferred shareholders requested redemption. In the interim Chadbourn was obligated, *inter alia,* to pay the dividends on the preferred, to carry the debt service on the $12,631,000 Indenture, and to pay off the $6 million bank loan completely.

Chadbourn had to deal with approximately $18.5 million of new indebtedness before it could redeem plaintiffs' preferred as promised. Undisclosed was the fact that Chadbourn had to either earn approximately $16 million before taxes and $8 million after taxes, refinance the $18.5 million of indebtedness, or sell an additional $8 million of new equity securities.

It is clear that Peat had full knowledge of these restrictions when it prepared the Standard proxy financial statements and certified that the financial statements and certified that the financial statements accurately described the financial condition and debt structure of Chadbourn. This certification was false and fraudulent as found by the District Court. Furthermore, between March 23, 1970, and April 1,

1970, prior to the merger, Hugh Freeze, the Peat manager in charge of the Chadbourn audit, received a phone call from Peat's attorney Herbert Browne, Jr., a member of the law firm of Helms, Mullis & Johnston, the firm that prepared parts of the proxy. Brown informed Freeze that the use of the word "common" in footnote 7(c) of the Peat audit was erroneous. Freeze then crossed out the word "common" on his copy of a preliminary draft of the Standard proxy footnote and wrote the word 'capital' underneath it. Peat, however, did not alter the proxy, or, if the proxy had already been mailed, Peat took no steps to notify Standard shareholders or the SEC to correct the alleged error before the Standard shareholders voted on the acquisition of Standard by Chadbourn. The District Court could rightly infer that the reason Freeze did not correct the original was because it would have defeated the merger as the Standard shareholders would not have approved it.

There is other direct evidence that Peat had actual knowledge of the alleged error in footnote 7 of the proxy statement before the merger vote was taken. At approximately the same time it was preparing the Standard proxy Peat was also drafting a proxy containing the same financial statement for use in soliciting votes for the acquisition of Continental Strategics Corporation by Chadbourn (the Continental proxy materials). The Continental proxy, like the UHM proxy, contained the correct word "capital" in footnote 7(c). The Continental proxy was mailed on April 8, 1970, approximately two weeks before the vote on the Standard merger. The Continental proxy was not mailed to Standard shareholders because the Standard merger had not yet been consummated.

As indicated, *supra*, Peat also prepared the UHM proxy which contained the correct word "capital" in footnote 7(c). In a letter to the SEC dated April 20, 1970, two days before the Standard merger vote, counsel for Chadbourn sent to SEC copies of the UHM proxy containing the proper word.

Early drafts of the footnotes from the summer of 1969 when the audit was conducted indicate that Peat originally intended to disclose verbatim the Indenture restrictions on dividend payment. When the existence of the bank loan agreement for $6 million required a revision of the financial statement the following fall, Peat's auditing manager Freeze wrote footnote 7(c) using the word "common." For footnote 7(d) Freeze discarded the verbatim language of the Indenture restricting dividend payment and characterized the Indenture restrictive covenants as "less restrictive than those contained in the note agreement with the three banks." This characterization of the Indenture covenants appeared in all of the certified financial statements in issue until counsel for Chadbourn stated the Indenture dividend restriction in full in the 1971 Chadbourn Annual Report and stated the Indenture restrictions on redemption as well.

Despite all this evidence of deliberate fraud, Peat has the audacity to assert that the false, untrue and misleading statements in footnotes 7(c) and 7(d) of its audit were only "lapsus calami" (Br. at 5), "slip of the pen" (Br. at 29), and a "footnote mistake" (Br. at i). It is unbelievable that the majority of this panel would swallow with hook line and sinker such an outrageous and ridiculous proposition and to hold that Peat's misrepresentation was only negligent and use it as a basis for reversing a well reasoned opinion of the District Court thereby depriving the many share holders of Standard of millions of dollars of compensation in which they were justly entitled because of the fraud perpetrated on them by Peat. If it originally was only a slip of the pen, it became a deliberate fraud when Peat's own lawyer called this to the attention of Peat's manager in charge of the audit and the employee corrected the alleged mistake in his copy and did not correct the original because it would have defeated the merger. The characterization of Peat's misrepresentation as a "negligent misrepresentation" adds something new and unheard of in our jurisprudence.

The District Court characterized it differently. It found that Peat's Certificate that it had performed its 1969 Chadbourn audit in accordance with generally accepted accounting standards and auditing practices and false and untrue and that Peat Acted "willfully, with intent to 'deceive' and 'manipulate' and 'in reckless disregard of the truth' in respect to footnotes 7(c) and 7(d) in said audit. In my opinion, the majorities holding should be rejected and the factual findings of the District Court upheld.

In imposing liability the District Court followed the standards of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) with respect to the necessity of proof of scienter as mere negligence is not enough to violate the Act. The District Court in finding scienter stated:

> [n]otwithstanding this stringent element of proof, the court concludes that in all the facts and circumstances of this case, scienter on behalf of defendant has been established by a preponderance of the evidence.
>
> On two occasions when it counted most, with full knowledge of the correct term, Peat, deliberately, did not correctly describe the stock which was restricted in the payment of dividends by the bank loan which stock also was the particular class plaintiffs would receive by the merger. Furthermore, defendant never fully described either the dividend restrictions on preferred stock contained in the indenture or the redemption restrictions contained in the indenture or the redemption restrictions contained in the indenture and loan agreement. Defendant's agents documented Chadbourn's numerous edp defects at the time of the 1969 audit and approximately one year later some corrections had been made but a considerable number of deficiences still remained – yet defendant did not feel obliged to report this to plaintiffs. Finally with full knowledge of Chadbourn's deficient edp and other internal weaknesses, defendant conducted its 1969 audit as though Chadbourn

> was as sound as a dollar used to be – clearly deviating from GAAP, GAAS and the provisions of Peat's own audit manual. The court finds and holds the proof in this case clearly established that, with the knowledge defendant possessed prior to, during and after the 1969 audit compared against the content of the [sic] Peat's 1969 Chadbourn financial statements, defendant acted willfully, with intent to "deceive" and "manipulate" and in "reckless disregard for the truth." App. 389a-90a.

Unlike the present case, in *Ernst & Ernst,* "the respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst." The Supreme Court did not determine whether reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5.

In *Mansbach* v. *Prescott, Ball & Turben,* 598 F. 2d 1017, 1024, No. 77-3226 (6th Cir. May 7, 1979), however, we upheld the sufficiency of recklessness to establish civil liability under the Act and that such claims should be liberally construed in order to effectuate the policies underlying the federal securities laws.[1]

The District Court was correct in finding that the deliberate misstatements and fraudulent omissions in the proxy statement were material. It is clear that no prudent Standard shareholder in his right mind would ever have voted for the merger if he had known of the restrictions on the payment of dividends and on the redemption of the cumulative preferred stock which he was to receive under the terms of the merger. The Standard stockholder had been receiving regular dividends on his Standard common stock. Because of the restrictions on the preferred stock which he was to receive in

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[1] The majority opinion impliedly overrules our decision in *Mansbach* but this is not an uncommon practice in our court for one panel to overrule the decision of another panel. See article in Harvard Law Review Volume 92:931, 934, 935 on Appealability of Orders Relating to Ongoing Grand Jury Procedures. *General Motors Corp.* v. *United States.* Also as pointed out herein, the applicable decisions of the Supreme Court were not even followed.

exchange he would not receive any dividends on the preferred stock for a long time and possibly he would never receive either the dividends or secure the redemption of the preferred shares. Under the law it was not necessary to prove that each shareholder of Standard relied on the representations contained in the proxy statement and financial statement mailed to them and to SEC. *Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128, 153-54 (1972); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970). The majoriyt opinion is inconsistent with the holdings in these cases and with the reasoning of the Supreme Court in *Chiarella* v. *United States*, No. 78-1202, 48 L.W., No. 36, pages 42-50.

As before stated 22 percent of the outstanding Standard common shares was held in trust by a Knoxville bank in fiduciary accounts.

Because of the finding of liability by the District Court on the basis of section 10(b) of the Act and Rule 10b-5, I need not address the issues of Peat's liability under section 14(a) and Rule 14a-9, as an aider and abetter.

I also approve of the findings and conclusions of the District Court with respect to causation because materiality was established.

The majority does not discuss issues raised by Peat on the statute of limitations, damages and attorneys fees. I will therefore not discuss them.

In my opinion, the majority should have treated these matters so that it would not be necessary to remand the case to our court in the event the Supreme Court reversed this court on the issues of liability. This case has already been pending too long in the federal courts.

## II.

Although our decision with respect to violations of section 10(b) of the Act and Rule 10b-5 are dispositive of the

issue of liability, we also approve the findings and conclusions of the District Court as additional support with respect to Peat's false Certificate of the Chadbourn 1969 audit and the electronic data processing (edp).

The District Court found that Peat violated generally accepted auditing standards and generally accepted accounting principles (GAAS and GAAP) during the audit. Specifically, he found that Peat violated the following standards taken from Statements on Auditing Procedure No. 33 (SAP 33): the second and third general standards:

> 2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
>
> 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

the second standard of field work:

> There is to be proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

the third standard of field work:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

The Court further found Peat violated Statement on Auditing Procedure No. 41 (SAP 41), which sets forth a procedure for accountants to follow upon discovery of new material information to inform management and others known to be relying on such information. We believe that there is substantial evidence in the record to support such findings, and that they are not clearly erroneous. With respect to the

conduct of the audit, no working papers exist to verify that important auditing steps were performed during the audit. Peat's valuation of Chadbourn's inventory was poorly performed. Peat's employee Marston's working papers on the efficacy of Chadbourn's internal controls stated, "[c]ontrols is out of control!" Two letters from Peat to Chadbourn dated September 17, 1969, and December 22, 1970, show that Chadbourn's electronic data processing (edp) problems were widespread and pervasive in all internal accounting systems, yet Peat failed to adequately take these problems into consideration, or to demand a full manual audit at financial year end, only one month later, as required by Peat's own audit manual; indeed, Peat instead relied upon Chadbourn's internal accounting systems to adjust the audit figures so that the financial statement read as of August 2, 1969, instead of July 4, 1969. With respect to the discovery of new material, Peat failed to inform the Standard shareholders of its footnote mistake in the financial statement even though Peat had full knowledge of the alleged mistake well before the merger vote and the accounting profession in SAP 41 specifically set forth a procedure for disseminating such information. Obviously Peat did not correct its mistake because if it had corrected it, Standard would have rejected the merger.

The court further found that Peat's failure to disclose dividend restrictions on payment thereof and redemption of the $.46-2/3 preferred stock violated both Regulation S-X (Plf's Ex. 225-A) and Accounting Series Release No. 35. (Plf's Ex. 224).

James Quigley, a full partner of Peats, admitted on cross-examination that it was mandatory that redemption restrictions be disclosed.

In arriving at its factual findings with respect to the audit, the materiality of the omissions and misrepresentations by Peat and in internal control, the District Court was supported by the testimony of Larry E. Rittenberg, an assistant

professor, in the department of accounting of the University of Tennessee and George J. Benston, a distinguished professor of accounting and finance at the University of Rochester Graduate School of Management.

Professor Benston testified that Peat's footnote in the financial statement was incorrect because it did not disclose important aspects in the indenture and note agreement and violated Regulation S-X and Accounting Series Release No. 35.

Peat admitted it made a mistake but claimed it was inadvertant. The District Court found no mistake but a fraudulent omission of material facts. It was a fraud not only on Standard's stockholders but also on SEC.

The amicus brief of American Institute of Certified Public Accountants is noteworthy in its failure to discuss the main issue in this appeal, on which our decision is based, namely, the fraudulent footnote 7 of the Chadbourn financial statement contained in the Standard proxy materials written and certified as correct by Peat and mailed to Standard stockholders and filed with SEC. Instead, the Institute treats only one of the many issues in this case, namely, the liability of Peat for failure to disclose in its audit, weaknesses in the internal control of Chadbourn or require Chadbourn to make such disclosure.

If Peat desired to limit its liability it should have never attached to its audit the Certificate which it executed and was found by the District Court to be a false and fraudulent certification.

The District Court made a number of specific findings of fact with supporting record references with respect to Electronic Data Processing (EDP) deficiencies being Nos. 45 to 53 and held that Peat had a duty to disclose them to Standard's stockholders as prudent investors would be entitled to this information. Peat's failure to disclose this material information on its audit constituted a breach of duty of disclosure.

The District Court further made many specific findings of fact with supporting record references with respect to Generally Accepted Auditing Principles and Standards (GAAP and GAAS) being Nos. 54 to 102 from which it can be gleamed that the work performed by Peat was anything but a reliable audit. Finding (102) concludes: "The misrepresentation and omissions of defendant which have been fully documented in the Memorandum Decision and herein, were committed or omitted by Peat willfully, deliberately, with intent to deceive and manipulate and with reckless disregard for the truth."

## Conclusion

The requirement by law of the proxy statement with its certified audit and financial statement to be sent to the shareholders of an acquired company in a merger and filed with SEC, forms an important function for the protection of investors in the administration of the Securities Act by the Securities and Exchange Commission.

The Act can never be properly administered if deliberate, fraudulent, deceitful and recklessly made proxy statements such as were prepared by Peat for use in a corporate merger and for filing with SEC are ever tolerated. Its characterization by the majority as a "negligent misrepresentation" does not excuse the fraudulent omission by an auditor who owes a duty to disclose the truth. The District Court was correct in pointing out the many glaring deficiencies and fraudulent omissions in Peat's proxy statement and audit for which it was well paid. It should be required to compensate the victims of its frauds as ordered by the District Court.

The judgment of the District Court should be affirmed.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF TENNESSEE
NORTHERN DIVISION
CIVIL ACTION NO. 8052

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,
Plaintiffs,

and

BARRY J. McKEAN, JOHN STEPHEN McKEAN, in his own name and as Trustee for JOHN STEPHEN McKEAN, JR., a minor, and as Trustee for MELODY ANNE McKEAN, a minor, RICHARD S. BAGWELL, LAURA J. BAGWELL, ANNE J. TERRELL, MARY J. FOUST, MYVANWY J. BOYD, NEIL JOUROLMON, ANNE DOSSER JOUROLMON, LOIS JOUROLMON, LEON JOUROLMON, JR., MARTHA P. JOUROLMON, and LEON JOUROLMON, III,
Intervenors,

and

PAUL W. MANKIN, BLENDINE McRAE, CHARLES E. RADER, MAY F. NICHOLS, DELLA EZELL WIDENER, ELIZABETH COE CARMAN, ILIFF C. FISHER, GRACE F. CHRISMAN, ALBERT HOUSTON FRANKLIN and LUCILLE FRANKLIN,
Intervenors,

-vs-

STANDARD KNITTING MILLS, INC., successor by merger to SKM, INC. and STANDARD KNITTING MILLS, INC., each Tennessee corporation, CHADBOURN, INC. J. E. GETTYS, JACKSON C. KRAMER, HARRY J. NACEY, JR., E. B. RODGERS, J. B. WOOLSEY, J. CHADBOURN BOLLES, THOMAS N. ROBOZ, CURT SEIFART, E. M. HICKS, JR., J. W. JOHNSTON and PEAT, MARWICK, MITCHELL & CO.,
Defendants.

## MEMORANDUM DECISION

The court having fully considered depositions as marked, admitted exhibits, transcripts of testimony presented in trial November 10-22, 1975, the post trial memoranda and final argument of counsel and proposed Findings of Fact and Conclusions of Law submitted by counsel, the court hereby finds, holds and determines the issues presented as follows:

### A. STATEMENT OF THE CASE

1. *Factual Background*

In late 1968 or early 1969, Thomas N. Roboz, then president of Chadbourn, Inc. (Chadbourn) initiated discussions with representatives of Standard Knitting Mills, Inc. (Standard) concerning a possible merger of the two corporations.[1] On July 24, 1969, defendant, Peat, Marwick, Mitchell & Co. (Peat) acknowledged by internal memorandum, the engagement of their services by Chadbourn in preparing a "[p]roxy statement to be filed [with the SEC] for stockholders of Standard Knitting Mills, Inc. in connection with a proposed acquisition of Standard and its subsidiaries by Chadbourn."[2] For such services Peat charged Chadbourn 125% of Peat's standard rate for its services and was paid at that higher rate.[3] Merger negotiations continued and ultimately resulted in a plan and agreement of merger dated July 28, 1969.[4] An amended plan and agreement of merger was executed on October 13, 1969.[5]

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1. Roboz deposition (dep) 2/14/73 p 19, l 7-23.
2. Plaintiffs' Exhibit (Pl Ex) 229, 240, 256; Transcript (Tr) pp 75-76.
3. Pl Ex 229, 240, 256; Tr p 77, l 1-21.
4. Pl Ex 67.
5. Pl Ex 68.

In March of 1969 Chadbourn offered for sale to its shareholders and to the public $12,631,000.00 of 6-1/2% Convertible Subordinated Debentures, due March 15, 1989 pursuant to an Indenture dated March 15, 1969.[6]

In September of 1969, Chadbourn entered into a $6,-000,000. term loan agreement dated August 2, 1969 with the North Carolina National Bank, The First National Bank of Boston and The First National Bank of Atlanta.[7] The loan terms called for twenty consecutive, quarterly installment payments by Chadbourn of $150,000.00 each, commencing October 1, 1969 with a final installment due on October 1, 1974.[8]

By the merger agreement, Standard shareholders were required to approve the terms of merger.[9] The Notice of Special Meeting of Stockholders, a letter from J. E. Gettys, President of Standard, together with a proxy statement (Standard proxy statement) were all mailed to Standard shareholders on or after March 27, 1970.[10] The shareholder meeting was held on April 22, 1970 with more than 50% of the Standard common stock voted in favor of the proposed merger.[11]

Having approved the proposed merger, by the terms thereof shareholders of Standard were entitled to exchange and receive for every share of Standard common stock, 1.5 shares of Chadbourn $.46-2/3 Cumulative Convertible

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6. Pl Ex 1 and 2.

7. Pl Ex 3.

8. Pl Ex 3, pp 1-2.

9. Pl Ex 68 ¶ 12, p 7.

10. Pl Ex 76. Three letters from J. E. Gettys, President of Standard, preceded the mailing of the proxy statement informing Standard shareholders of the general terms of and timetable for consideration of the proposed merger. (Pl Ex 85, 92, 103).

11. Pl Ex 123.

Preferred Stock ($.46-2/3 preferred stock or Chadbourn junior preferred). A summary of the rights and priorities of the $.46-2/3 preferred stock was included at page 5 of the Standard proxy with a more detailed statement appearing at Appendix A to Exhibit A of the Standard proxy statement.[12]

Subsequent to the merger plaintiffs, former Standard common shareholders and then holders of the $.46-2/3 preferred stock, on or after May 27, 1970 were mailed a Notice of Special Meeting of Stockholders and a proxy statement seeking shareholder approval for a loan and option agreement with United Hosiery Mills, Ltd., Manhattan Hosiery Corporation and the majority holders of capital stock in Schulte & Dieckhoff GmbH (UHM proxy statement).[13]

For the fiscal year ended July 31, 1971, Chadbourn suffered losses totaling $17,585,313.00. Shareholders were informed thereof in writing.[14] The original complaint in this action was filed in this court October 12, 1972.

2. *Procedural Background*

The original complaint was filed by plaintiff Mary Lillian Adams[15] for herself and "on behalf of all former owners of Standard Knitting stock who now own, as a result of the merger exchange, the $.46-2/3 preferred stock of Chadbourn," whom she sought to represent in a class action.[16] Thereafter, numerous complaints in inter-

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12. Pl Ex 76.

13. Pl Ex 50.

14. Pl Ex 10; Defendant's (Def) Ex 509.

15. By order signed January 20, 1975, the court substituted Mark W. Adams and Charles Rader Adams for Mary Lillian Adams, who died October 30, 1974.

16. Complaint ¶ 17.

vention were filed on behalf of named intervenors as additional members of the class defined in the Adams complaint. On May 5, 1973, plaintiff filed a Motion for Determination of Class Action. (Order 10/29/73). Thereafter various plaintiffs amended their complaints.

After full briefing and oral argument concerning class action, on October 29, 1973, the court granted plaintiff's Motion for Class Determination and forwarded for entry an Order specifying the provisions of the court's decision. The class was defined by the court to be "all former holders of Standard Knitting stock who received Chadbourn $.46-2/3 preferred stock as a result of the merger exchange and still hold said stock," except that all defendants in the case holding Chadbourn $.46-2/3 preferred stock shall be excluded from the class, and "interveners shall be excluded unless they elect to join the class." (Order 10/29/73). All intervenors subsequently so elected.

On December 21, 1973, the court broadened the class to include "heirs and successors in interest" to holders of the Chadbourn junior preferred and established and defined a subclass as "persons who received Chadbourn $.46-2/3 preferred stock as a result of the merger exchange and their heirs or successors in interest by operation of law, *who thereafter disposed of said stock . . .*" (emphasis added). (Order 12/21/73). By order signed June 12, 1974 the court directed that Neil Jourolmon act as representative of the subclass and that Charles E. Rader serve as counsel for the subclass.[17]

By a judgment signed June 11, 1975, after class notice and a full, open court hearing, the court approved settle-

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17. By letter dated June 7, 1974, Charles E. Rader informed the court that duties of representing the subclass would be shared with Leon Jourolmon.

ment of the claims of the class and subclass against all defendants (settling defendants),[18] other than defendant Peat.

3. *Plaintiffs' Contentions*

Plaintiffs claim, inter alia, (1) that defendant's footnotes 7(c) and (d) to its financial statements contained in the Standard proxy statement were false and misleading; (2) that defendant's failure to disclose or to compel Chadbourn's management to disclose that it had serious and continuing problems in electronic data processing (edp) was a material omission; (3) that defendant's failure to disclose that the 1969 Chadbourn audit was not conducted in accordance with generally accepted auditing standards and principles (GAAS and GAAP) constituted a material omission; and (4) that all of the foregoing misconduct proximately caused plaintiffs to suffer substantial monetary damages. Plaintiffs contend that the asserted facts establish defendant's liability under §§12(2), 15 and 17 of the Securities Act of 1933 and §§10(b), 14 and 18 of the Securities Exchange Act of 1934, as well as rules 10b-5 and 14a-9 of the Securities and Exchange Commission promulgated thereunder.[19]

4. *Peat's Contentions*

(a) Peat contends the evidence does not support the factual contentions of plaintiffs in the following particulars:

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18. Standard Knitting Mills, Inc.; successor to SKM, Inc.; Standard Knitting Mills, Inc.; Chadbourn, Inc.; J. E. Getty's Jackson C. Kramer; Harry M. Nacey, Jr.; E. B. Rodgers; J. B. Woolsey; J. Chadbourn Bolles; Thomas N. Roboz; Curt Seifart; E. M. Hicks, Jr.; and J. W. Johnston. Specifically excluded from the release of claims contained in the judgment was defendant Peat.

19. Pretrial Order (PTO) ¶(1)(a) p 1.

(1) The matters Peat allegedly failed to disclose in footnotes to the financial statements were revealed in the forepart of the Standard proxy statement.

(2) Plaintiffs have not proven that Peat-prepared financial statements were inaccurate.[20]

(b) Peat contends that its legal arguments below stated preclude a finding of liability on any of plaintiffs' claims:

(1) §10(b) (15 U.S.C. §78j(b)) and Rule 10b-5 17 C.F.R. §240.10b-5):

Peat contends that plaintiffs failed to establish all of the essential elements for 10b-5 liability, which are, that "(a) Peat, Marwick misrepresented a fact or omitted to state a fact which it was under a duty to disclose and that plaintiffs were not cognizant of that fact; (b) the fact was material; (c) Peat, Marwick acted with the requisite degree of culpability; (d) with respect to the challenged conduct Peat, Marwick was under a duty which ran to plaintiffs and their interests which they allege was breached; and (e) Peat, Marwick's violative conduct caused plaintiffs to purchase or sell securities and (f) that thereby plaintiffs suffered the loss of which they complain."[21]

(a) That a statement by Mr. Kramer, General Counsel and a Director of Standard, made at the Standard shareholder meeting, to the effect that there were no restrictions on the payment of dividends on the $.46-2/3 preferred stock constituted an intervening and superseding cause of any loss or damage sustained

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20. Def Trial Memorandum p 29; Def post-evidence memorandum (PEM) p 166.

21. Def PEM p 170.

by plaintiffs and, even if Peat is found liable, Kramer's statement absolves defendant of that liability.[22]

(2) §14 (15 U.S.C. §78n)[23]

(a) That plaintiffs have not proven Peat solicited the Standard proxy statement, which defendant contends is an essential requirement.

(3) §18 (15 U.S.C. §78r).

(a) That plaintiffs have neither proven fraud nor individual reliance on any false or undisclosed information chargeable to Peat.

(4) §12(2) 15 U.S.C. §77 1 (2).

(a) Plaintiffs have not established privity between Peat and plaintiffs or that Peat participated in an effort to sell securities.

(5) §15 (15 U.S.C. §77 o).

(a) Plaintiffs have neither proven that defendant was a "controlling person" nor established the identity of the person or entity controlled.

(6) §17 (15 U.S.C. §77c).

(a) Defendant contends plaintiffs have neither established that §17 provides a private civil cause of action nor offered authority to such effect.

(c) Statute of Limitations:

(1) §10b, Rule 10b-5, §14 and §17.

Defendant contends plaintiffs' claims based on the foregoing provisions are time-barred by Tennessee limitation periods.

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22. Def PEM 222-24.

23. Although not specifically denominated as such, the court will presume this defense applies equally to plaintiffs' rule 14a-9 claim.

(2) §12(2) and §18.

Defendant contends plaintiffs' claims based on the foregoing sections are barred by the terms of federal securities laws limitation provisions.

## B. SUMMARY OF FINDINGS OF FACT

Prior to summarizing the Findings of Fact, several of many other facts which the court considers determinative of this litigation will be emphasized.

On or after April 8, 1970, shareholders of Continental Strategics Corporation (Continental) were mailed copies of a proxy statement seeking approval of a proposed merger with Chadbourn. Peat prepared financial statements and footnotes for inclusion in the proxy statement, which footnotes contained language almost identical to Peat's footnote language in the Standard proxy statement. However, in the final form, indeed, in the preliminary drafts of the Continental footnotes, defendant's employees, by hand, deliberately changed the word "common" to "capital" to accurately describe which class of stock was restricted in the payment of dividends by the bank loan agreement.[24] The early drafts of Continental footnotes also described the financial extent to which payment of dividends were restricted by the bank loan agreement[25] which Peat later deliberately deleted.

In the Standard proxy statement mailed on or after March 27, 1970, just twelve days prior to the mailing of the Continental Proxy Statement, the incorrect term, "common" was used to describe the stock which the bank loan agreement restricted in payment of dividends.[26] In-

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24. Pl Ex 27g, h, 34, 40, 46 and 47.

25. Pl Ex 27g.

26. Pl Ex 76, footnote 7(c).

disputably, Peat had knowledge of the correct term well before the mailing of the Standard proxy statement, in which it knowingly used the incorrect term, as evidenced by defendant's drafts of the early Continental footnotes.[27] Moreover, Peat's manager of its audit, Hugh Freeze, was informed by telephone sometime between March 23 and April 1, 1970 by Herbert Browne, Jr., an attorney for Chadbourn, that defendant's footnote 7(c) was incorrect in describing dividend restrictions on "common" rather than "capital" stocks.[28] During that phone conversation Freeze even crossed out the word "common" and wrote in "capital" underneath it on a copy of a preliminary draft of the Standard Proxy.[29] Peat did not inform Standard shareholders of the correction or anyone else. Defendant corrected the "common" - "capital" error in the UHM Proxy mailed on or after May 27, 1970.[30] Without explanation or justification, defendant repeated the same error in the 1970 Annual Report for Chadbourn mailed to stockholders sometime after November 5, 1970.

Defendant was content to describe the restrictions in the indenture as follows: "[f]urther, the indenture has certain restrictive covenants but they are less restrictive than those contained in the note agreement with the three banks."[31] The foregoing description appeared in the Continental Strategics, Standard and UHM proxy statements as well as the 1970 Chadbourn Annual Report.[32] In preliminary drafts of the Continental proxy statement defendant had included the full text of restrictions on dividend

27. Tr 130-32.
28. Pl Ex 61; Tr 2188.
29. Pl Ex 43; Tr 2187-88.
30. Pl. Ex 50 n 7(c).
31. Pl Ex 27h, 34, 40, 46, 47.
32. Pl Ex 51, 76, 50, 9.

payment and redemption of stock contained in the indenture.[33] In the final version the full text of the indenture restrictions was deleted. Yet in the 1971, 72 and 73 Annual Reports for Chadbourn, defendant deleted the foregoing quoted language and described indenture restrictions as follows: "[f]urther the indenture contains a restrictive provision under which the Company cannot declare any dividends or make any distribution (other than capital stock dividends), or acquire any of its stock if, after such action, the aggregate of all dividends (other than stock dividends), other distributions to stockholders and all amounts paid for the acquisition of its stock would exceed the sum of (1) $2,000,000 plus (ii) the net proceeds of the sale for cash by the company of any shares of its capital stock after August 3, 1968 plus (iii) consolidated net income realized after August 3, 1968."

Mr. Johnston, General Counsel for Chadbourn prepared the foregoing text of indenture restrictions for defendant's inclusion into the 1971 and later Annual Reports for Chadbourn, following disagreement with defendant as to the meaning and extent of the indenture restrictions.[34]

Because defendant's services in connection with the Standard proxy statement included filing with the SEC, defendant charged 125% of its standard rates because of the increased risk assumed by Peat.[35] Notwithstanding the higher fee, defendant admitted it exercised no greater standard of care in performing those services for Chadbourn.[36]

As to the restrictions on the redemption of the $.46-2/3 preferred stock, defendant's witness James Quigley,

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33. Pl Ex 315, 325A, 26, 24.
34. Tr 2201-02.
35. Tr 79, 1 2-3.
36. Tr 78, 1 21-22.

a full Peat partner whose substantial personal interest in this litigation cannot be disputed, testified that he believed it mandatory for Peat to disclose redemption restrictions essentially the same as those on the Chadbourn preferred stock contained in the bank loan agreement and in the indenture.[37] Near the end of trial, the court expressed concern regarding the admissibility and weight to be given Quigley's testimony, since he was designated one of the defendant's expert witnesses and was a partner of Peat. The court also noted the concerns of plaintiffs' counsel with respect to these matters.[38] In a separate memorandum addressed to this question, defendant cited relevant authorities for the proposition that any bias or interest Mr. Quigley may have as a result of his being an employee of defendant is a matter to be considered by the court in determining the weight to be accorded his testimony. The court agrees with defendant and for this reason the court declines to strike or deny admission of any of Quigley's testimony. The Quigley testimony, briefly stated in the first sentence of this paragraph, convinces this court, regardless of any other testimony to the contrary, that Peat had a duty which it failed to discharge by not disclosing the restrictions on redemption of Chadbourn preferred stock as spelled out in the bank agreement and the indenture. In all other particulars, this court finds Quigley's testimony of questionable credibility unless corroborated by evidence the court deems credible.

As to Chadbourn's edp deficiencies, the defendant in addition to others, noted numerous and serious defects which were reported by them to Chadbourn.[39] Yet de-

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37. Tr 2332-33.

38. Tr 2258.

39. Pl Ex 164, 165, 166, 178, 311.

fendant failed to disclose, or compel Chadbourn to disclose, these weaknesses to Standard shareholders. After completion of Chadbourn 1969 audit, the edp shortcomings plus other deficiencies rendered Chadbourn's internal control weak, jeopardizing the validity of vital business statistics, yet Peat conducted the audit as though these problems did not exist.[40] The testimony of defendant's employee, William Brasington, was offered by Peat to bolster defendant's contention that proper tests of the physical inventory were made. Four work papers selected at random by Brasington contained a number of significant deficiencies: absence of meaningful testing, no testing and substantial discrepancies in test results.[41]

Other similar shortcomings in Peat's performance of its duties and responsibilities to Standard stockholders are mentioned below and in the detailed written Findings of Fact and Conclusions of Law entered with Judgment in this case.

1. *Standard Proxy Statement*

Footnotes 7(c) and (d).

(a) 7(c). Plaintiffs contend that the foregoing footnote was materially misleading in that 7(c) did not disclose provisions of the bank loan agreement restricting payment of dividends on the $.46-2/3 preferred stock.[42] Plaintiffs further contend that 7(c) did not disclose that the bank loan agreement restricted redemption of the $.46-2/3 preferred stock.[43]

Defendant acknowledges that in 7(c), when referring to restrictions on the payment of dividends, Peat used

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40. Tr 540-42; 441-551; 631-34.
41. Tr 1758, 1796, 1785, 2146, 1795.
42. PTO ¶53 p 19.
43. PTO ¶58 p 19.

the incorrect word "common" rather than the correct word "capital." In this context "common" clearly gave readers, especially plaintiffs, the right to assume that restrictions on the payment of dividends related only to common stock whereas in reality, the restrictions applied to "any class" of stock.[44] Defendant has the temerity to describe this unmistakable error as an "imprecision." The subject matter of footnote 7(c) is the bank loan agreement, the terms of which make it undeniably clear that the incorrect use of "common" was a serious and inexcusable error. The relevant portion of the bank loan agreement is that Chadbourn will not:

> "5.3 Declare or pay *any dividend* on its capital shares of *any class or make any distribution to any shareholders* as such (other than dividends or distributions payable solely in common stock of the Company and other than cash paid in lieu of fractional shares in connection with any such dividend payable solely in common stock of the Company), *or purchase, redeem or otherwise acquire for value any shares* of its stock of *any class*, if, after giving effect to such action, the aggregate of:
>
> (a) all dividends, other than in common stock of the Company, on its capital shares of all classes, preferred and common, and all other distributions to shareholders as such (other than cash paid in lieu of fractional shares in connection with any dividend payable solely in common stock of the Company) between August 2, 1969 and the time of taking such action; plus
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> (b) all amounts paid out for any redemptions, purchases or other acquisitions of its stock of any class (other than amounts paid for redemp-

44. Pl Ex 3, p 9.

tions of any shares of the Company's 6% Cumulative Preferred Stock, $50 par value) between August 2, 1969 and the time of taking such action; plus

(c) the amount of all payments required to be made, and of all prepayments made, on principal of the Note prior to the time of taking such action;

would exceed the sum of:

(y) $2,000,000; plus

(z) the consolidated net earnings of the Company and its subsidiaries accumulated subsequent to August 2, 1969; . . ." (emphasis added). Pl Ex 3, pp 9-10).

By this language, Chadbourn was clearly restricted in paying dividends and redeeming stock to the financial extent described above. Defendant suggests that somehow the fact that by its terms the bank loan was to be paid off on October 1, 1974, "6 months before the first offer to redeem preferred stock,"[45] absolves Peat of responsibility for its failure to disclose restrictions on dividends and stock redemption. That a bank loan agreement existed which restricted payment of dividends and redemption of preferred stock, the court finds was vital information which should have been disclosed to plaintiffs.

Defendant cites a number of sources of accounting principles to the effect that even "if there had been a meaningful restriction on Chadbourn's right to redeem, its disclosure would not have been required in the financial statements in contrast to the forepart of the proxy statement." The fact of the matter is that the cited authorities,

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45. Def PEM p 49.

at a minimum, required defendants to disclose the *dividend restrictions* and their "pertinent provisions." Standard shareholders upon approving the merger exchanged their shares of Standard common for a new class of Chadbourn stock - the $.46-2/3 preferred stock. The court finds and holds that in the circumstances of this case, clearly, knowledge of dividend restrictions on plaintiffs' Chadbourn junior preferred stock was highly pertinent to them, and especially significant in considering whether or not to vote in favor of the proposed Chadbourn merger.

As to the defendant's contention that there is no accounting requirement compelling disclosure of redemption restrictions; first, the court notes that accounting principles are usually of a general nature.[46] Secondly, the redemption provisions of the $.46-2/3 preferred stock were a unique aspect of the plan of merger negotiated between Standard and Chadbourn. A review of the numerous accounting authorities and principles cited in this case indicate an intent to provide for full disclosure in financial statements. This is to enable persons relying thereon to make sound and reasoned investment decisions by having all relevant financial information disclosed to them. Beyond doubt Peat knew plaintiffs would be relying on its financial statements and that the information regarding the $.46-2/3 preferred stock would be a particular interest to plaintiffs in making a decision whether or not to approve the merger. In these unique circumstances defendant's failure to fully and fairly disclose is clearly a serious breach of professional responsibility.

Defendant next contends that the correction of "common" and "capital" language in the UHM proxy statement absolves defendant of liability.[47] Peat made no effort to

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46. Def PEM pp 51-56.

47. Def PEM p 60.

highlight or call this modification to the attention of the plaintiffs. Although defendant included unaudited figures for a certain time period, it is unreasonable to assume plaintiffs would examine closely the financial statements and footnotes of Chadbourn contained in that proxy statement, considering it had been only two months since plaintiffs had fully read Chadbourn's reported financial condition in the Standard proxy. Further, the purpose of the UHM proxy was to seek shareholder approval of a transaction with other companies whose financial condition would be of paramount concern to plaintiffs and Chadbourn shareholders. Finally, as stated above, in the 1970 annual report for Chadbourn, Peat again made the same error in noting restrictions on the payment of dividends applied to "common" rather than "capital" stock.[48] Peat's counsel points to testimony of one of defendant's employees who attributed the mistake to "drafting error";[49] however, in view of all the facts found by the court, it must be further found that the second error in the long term debt footnote was wilful and designed to conceal the truth of defendant's previous inexcusable error from plaintiffs. The court has not found and Peat has not suggested any other reasonable explanation for defendant's conduct in all of the particulars discussed by the court throughout this section.

Lastly, Peat claims that at the same moment it learned of the inaccuracy in footnote 7(c) it became aware that a "precise description" of the loan agreement restrictions was contained in the forepart of the proxy statement.[50] This assertion is not persuasive, in view of the fact that the "precise description" of the restrictions was listed under a section entitled "Chadbourn *Common* Stock," a section in

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48. Pl Ex 9, footnote 6(c) p 20.
49. Def letter 3/2/76 p 2.
50. Def PEM p 69.

which plaintiffs would have had little, if any, immediate interest.[51]

(b) 7(d). Plaintiffs contend Peat made no disclosure of the restrictions contained in the indenture on dividend payments and the redemption of plaintiffs' $.46-2/3 preferred stock. The relevant language of the indenture is provided below:

> "Section 5.05. The *Company will not* declare or pay any dividends or *make any distribution* on or *with respect to its capital stock,* except for dividends payable solely in capital stock of the Company and except for cash paid in lieu of fractional shares in connection with any such dividend payable solely in capital stock of the Company, and will not permit any subsidiary to, directly or indirectly purchase, redeem, or otherwise acquire for a consideration any capital stock of the Company if the aggregate amount of all such payments or distributions after August 3, 1968 would exceed the sum of
>
> (i) $2,000,000 plus
>
> "(ii) the net proceeds (exclusive of any underwriting discounts or commissions or other expenses paid or incurred by the Company in connection therewith) of the sale for cash by the Company of any shares of its capital stock after August 3, 1968 *less* the amount paid by the Company for the purchase with cash of any shares of its capital stock after August 3, 1968 plus
>
> "(iii) Consolidated Net Income realized after August 3, 1968. (emphasis added) (Pl Ex 1 p 25)

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51. Pl Supplemental Memorandum (sup mem) pp 10-11.

There can be no dispute that by its terms Chadbourn was restricted in paying *dividends* on plaintiffs' $.46-2/3 preferred stock. The accounting authorities cited by defendant compel disclosure of restrictions on the payment of dividends yet Peat did not make note of such restrictions. Indeed, whereas the bank loan should have been paid off October 1, 1974, plaintiffs as respective recipients of merger benefits and liabilities, certainly would want to know and Peat should have disclosed, that by the terms of the indenture, the foregoing restrictions on dividend payments could have continued in effect until March 15, 1989, fifteen years after 1974.

Defendant contends that by the plain meaning of the terms of the indenture, Chadbourn was not restricted in redeeming plaintiffs' preferred stock but Chadbourn's subsidiaries were. Peat has not claimed any special knowledge or ability to interpret indenture language, therefore, its self-serving interpretation is not given weight or credibility by this court, especially since Miles Siegel, Dr. Benston and Chadbourn's counsel, J. W. Johnston, all agreed there *were* indenture restrictions on redemption.[52] Furthermore, defendant's expert, Frank Weston, testified that there could be differing conclusions with respect to the meaning of the indenture language.[53] Also Freeze testified that he relied on Mr. Johnston to draft the language describing the indenture restrictions in the 1971 financial statements, which language in relevant part is as follows:

> "Further, the indenture contains a restrictive provision under which *the Company cannot* declare any dividends or make any distribution (other than capital stock dividends), or *acquire any of its stock if,*

52. Pl sup memo p 5.

53. Tr p 1583.

after such action, the aggregate of all dividends (other than stock dividends), other distributions to stockholders and all amounts paid for the acquisition of its stock would exceed the sum of (i) $2,000,000 plus (ii) the net proceeds of the sale for cash by the Company of any shares of its capital stock after August 3, 1968 plus (iii) consolidated net income realized after August 3, 1968 and prior to July 31, 1971, the aggregate amount of all dividends, other distributions to stockholders and amounts paid for the acquisition of its stock by the Company was equal to $530,820. Since July 31, 1971, the Company has paid dividends on preferred stocks of $110,055 on September 1, 1971 and $3,167 on October 1, 1971. (emphasis added) (Pl Ex 10)

Similar language was included in the 1972 and 1973 annual reports of Chadbourn.[54] In sum, the court finds the construction given the indenture provision by defendant to be totally without merit, accordingly, the court finds and holds the language of §5.05 in the indenture restricted the redemption of plaintiffs' preferred stock and was a material matter which defendant should have disclosed and failure to do so was a material violation of professional duty to plaintiffs by Peat.

2. *Failure to Disclose EDP Problems*

The testimony of Dr. Larry Rittenberg is replete with examples of gross deficiencies and errors, many of which were acknowledged by Peat's staff, in the Chadbourn edp both prior to, during and subsequent to the time Peat was conducting the 1969 audit.[55] Among the more significant examples are:

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54. Pl Ex 11 & 12.

55. Tr 428-777; Pl sup mem pp 13-27.

(1) Mr. T. Marston, an employee of Peat, conducted a four-day review of Chadbourn's edp system prior to preparing a formal management letter to Chadbourn detailing edp deficiencies. In his work papers, in addition to finding other edp defects, Marston noted, "controls is out of control."[56]

(2) Peat's management letter to Chadbourn dated September 17, 1969 contains a full identification of all the weaknesses of Chadbourn's edp system which, when combined, indicated serious edp deficiencies which urgently needed correction.[57]

(3) Peat further noted in a later management letter dated December 30, 1969, edp weaknesses in the area of the Inventory Management File (IMF) control and cost accounting.[58]

(4) In another management letter to Chadbourn dated December 22, 1970, Peat noted some improvement in Chadbourn's edp system but discovered the continuing existence of a number of deficiencies reported 15 months earlier in the September 17, 1969 management letter. Of this fact, Dr. Rittenberg said, ". . . we have gone now a year later and the data processing control problems still have not been solved, that there are basic pervasive types of control problems."[59]

Plaintiffs contend that "Chadbourn's data processing created weaknesses in Chadbourn's system of internal control" which Peat relied on without reasonable or satisfactory verification. Defendant contends, inter alia, that only certain information and reports were utilized by Peat and that these reports did not suffer the same errors and

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56. Tr 468.
57. Pl Ex 164.
58. Pl Ex 165.
59. Tr 505-506.

weaknesses cited by plaintiffs in other of Chadbourn's edp reports and data output. Plaintiffs' testimonial and documentary evidence clearly established that in 1969 prior, during and subsequent to Peat's audit, Chadbourn's edp was suffering from significant errors in both input and output, as well as distinct shortcomings with respect to controls, to name but a few. These weaknesses were pervasive. Information fed into the computer could be printed out in a number of different reports and forms. From the fact that some significant errors in input and in reports were discovered, the court considers it a reasonable inference that errors not discovered were contained in reports and other output from the Chadbourn computer.

Defendant makes a belated attack on the qualifications and testimony of Dr. Rittenberg and moves to strike his testimony. The court found the qualifications of Rittenberg to be amply sufficient to admit his testimony, and to permit him to express opinions and conclusions on the edp problems and audit procedures of Chadbourn during the relevant time period. In fact, the court finds that in many instances Rittenberg's edp testimony was substantially more credible and convincing than the testimony of defendant's witnesses on the same subject matter. Accordingly, defendant's motion to strike the Rittenberg testimony is hereby denied.[60]

In sum, the court finds and holds that in various particulars defendant failed to follow and apply general accounting principles which was essential for fair presentation of Chadbourn's financial position and the results of its operations, by not disclosing or compelling Chadbourn management to disclose its gross edp deficiencies.

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60. Defendant at page 105 of its PEM belatedly makes objection to evidence admitted into evidence at trial and which after a review of the relevant authorities, including the Federal Rules of Evidence, is hereby overruled.

3. *Failure to Conduct the 1969 Chadbourn Audit in Compliance with Generally Accepted Accounting Standards and Practices (GAAS and GAAP)*

The court finds and holds the 1969 Chadbourn audit was not conducted in conformity with GAAP and GAAS. In reaching this conclusion the court reviewed all of the information, facts and circumstances available to and in possession of defendant in 1969. In areas of internal control, especially inventory, order entry system, cost control, edp, accounts receivable, inventory work forward and standard costs the court specifically finds and holds that Peat violated the second standard of field work;[61] the second general standard of auditing;[61a] the third general standard of auditing;[62] and the third standard of field work.[63]

Further, the court finds and holds that defendant's failure to disclose dividend restrictions on payment thereof and redemption of the $.46-2/3 preferred stock violates both Regulation S-X[64] and Accounting Series Release No. 35.[65]

## C. DISCUSSION OF LEGAL ISSUES

1. *Statute of Limitations*

Defendant contends that plaintiffs' claims based upon §10b, rule 10b-5, §14, §17a, §12 and §18 of the Federal Securities Laws are time-barred. The critical dates are as follows:

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61. Pl Ex 219, Chapter 5, p 72.
61a. Pl Ex 21, Chapter 3, p 20.
62. Pl Ex 219, Chapter 3, p 18.
63. Pl Ex 219, Chapter 6, p 34.
64. Pl Ex 225-A.
65. Pl Ex 224.

| | |
|---|---|
| April 22, 1970 | Date of Merger |
| May 27, 1970 | Date on or after which UHM proxy statement was mailed to former shareholders of Standard common stock. |
| September 16, 1971 | Letter to Chadbourn shareholders from President and Chairman of the Board disclosing over 17 million dollars in losses for the fiscal year ended July 31, 1971. |
| October 12, 1972 | Date of filing plaintiff Adam's complaint. |

(a) *Section 12*

The applicable limitation period for claims based on §12 is stated in §13 (15 U.S.C. §77m), which provides in substance that actions under §12 shall be brought within one year after actual discovery of the facts giving rise to the claim, or one year after such facts should reasonably have been discovered by the exercise of due diligence, but in no event shall any action be brought under §12 more than three years after a security sale or bona fide offer thereof to the public.

(b) *Section 18*

Claims under §18 are limited by the provisions of §18(c) which states that actions based thereon shall be brought within one year after discovery of the facts giving rise to the claim and within three years of the accrual of the claim.

Plaintiffs' filed suits are well within the three-year limitations provided in §12 and §18(c). Indeed, Peat only asserts that plaintiffs discovered or should have discovered the facts giving rise to their claims in excess of

one year prior to the filing of their claims, which was on October 12, 1972.

(c) *Section 10(b), Rule 10b-5, Section 14 and Section 17*

No federal statutory limitation period is prescribed in or for any of these rules or statutes.

Presented with the problem of determining a limitations period, federal courts have looked to the law of the forum state for a ". . . limitation period which the forum state applies to the *state remedy* which *bears the closest substantive resemblance to rule 10b-5,* and which *best effectuates its purpose. . . .*" (citation omitted and emphasis added). *Hudak v. Economic Research Analysts, Inc.,* 499 F.2d 996, 999 (5th Cir. 1974). *Accord, Charney v. Thomas,* 372 F.2d 97, 100 (6th Cir. 1967). *See, Gray v. International Ass'n of Heat & Frost I.&A.W. Local No. 51,* 416 F.2d 313, 316 (6th Cir. 1969); *International Union UAW v. Hoosier Cardinal Corp.,* 383 U.S. 696, 703 (1966).

In applying the standard of *Hudak* to the law of the forum state, Tennessee, the court concludes that the state provision which most closely resembles rule 10b-5 is T.C.A. §48-1644(B)[66] which provides:

> "48-1644. Fraudulent practices. — It shall be a fraudulent practice and it shall be unlawful:
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> . . . .
>
> "(B) For any person, in connection with any transaction or transactions in this state which involve any offer to sell or to buy securities, or any sale or purchase of securities, including securities exempted under the provisions of 48-1619 and including any transactions exempted under the provisions of 48-1632,

66. *Accord, Hitt v. Modern Maid, Inc.,* Civ. No. 6668 (ED Tenn. April 9, 1974); *Akridge v. Recovery Inns of America,* Civ. No. 6020 (ED Tenn. Jan. 29, 1971).

either directly or indirectly, (i) to employ any device, scheme or artifice to defraud or (ii) to engage in any act, practice, transaction or course of business which operates or would operate as a fraud or deceit upon the purchaser or seller.

"Sec. 48-1648. Penalties for Violations. . . .

"any person who shall engage in a fraudulent practice declared unlawful in sec. 48-1644, shall be guilty of a *felony* and upon conviction thereof, shall be punished by a fine of not less than fifty dollars ($50.00), nor more than five thousand dollars ($5,000), or by imprisonment in the state penitentiary for not less than one (1) year nor more than five (5) years, or by both such fine and imprisonment. (Emphasis added).

There is no specific limitation period contained in §48-1644 which precludes or limits any civil action based thereon. When confronted with the problem of identifying the appropriate state limitation period to be applied to §10 (b), rule 10b-5, and §17 federal securities law claims, the Sixth Circuit and Tennessee federal judges have responded differently.

In *Charney v. Thomas, supra,* the Sixth Circuit reversed and remanded a district court dismissal based upon that court's application of the Michigan Blue Sky Law limitation period. The court found that ". . . Michigan law contains no provision similar to Section 10(b) of the federal law."[67] Therefore, the normal, six year common law fraud limitation provision was applied and plaintiffs' claims were not time-barred.[68] In *Denny v. Performance*

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67. *Charney, supra,* at p 100.

68. *Charney* was reaffirmed just recently by the Sixth Circuit in *IDS v. First of Michigan Corporation,* No. 75-1475-77 (6th Cir. April 16, 1976) wherein the court provided

"Moreover, we agree that the 'broad remedial policies of the federal securities laws are best served by a longer, not a shorter statute of limitation.' " (citation omitted) p 6.

*Systems, Inc.*, Civ. No. 6134 (M.D. Tenn. Nov. 5, 1971), Judge Morton held that the one-year limitation provision of T.C.A. §48-1645(A) would not apply to 10b-5 actions because §48-1645 is not the Tennessee Blue Sky Law equivalent of rule 10b-5, therefore, it would be improper to apply the §48-1645(A) limitation thereto. Because of its relevance to the present action the text of T.C.A. §48-1645 is provided in relevant part:

> "48-1645. Voidable Sales—Settlement—Remedies—Limitations. *Every sale* or contract for sale made in violation of any of the provisions of this chapter, or of any order issued by the commissioner under any provisions of this chapter, *shall be voidable* at the election of the purchaser. The person making such sale or contract for sale, and every director, officer, salesman or agent of or for such seller who shall have participated or aided in any way in making such sale, shall be jointly and severally liable to such purchaser, in any action at law in any court of competent jurisdiction upon tender to the seller, in person or in open court, of the securities sold or of the contracts made, for the full amount paid by such purchaser together with all taxable court costs and reasonable attorney's fees in any action or tender under this section; provided:
>
> "(A) That no action shall be brought under *this section* for the recovery of the purchase price after one (1) year from the date of such sale or contract for sale.
>
> (B) That no purchaser shall claim or have the benefit of this section if he shall have refused or failed to accept a bona fide offer in writing of the seller, within thirty (30) days from the date of such offer, to take back the securities in question and to refund

the full amount paid by such purchaser, together with interest on such amount for the period from date of payment by such purchaser to the date of repayment, such interest to be computed; . . ." (emphasis added).

Judge Wilson in *Akridge v. Recovery Inns of America, supra,* denied defendants' motions to dismiss plaintiffs' claims as being time-barred by applicable statutes of limitation. Apparently the denial of the motion was due to the fact that defendants did not supply the court with supporting affidavits or memoranda.[69] The court went on, however, to note that T.C.A. §48-1644(B) was the Tennessee Blue Sky Law provision most similar to rule 10b-5 and that the limitation provided in §48-1644 "should control claims made under §17a, §10(b), and rule 10b-5." *Akridge, supra,* at p. 6. Notwithstanding the patent ambiguity in the court's reference to a limitation period provided in §48-1644, the court's comments with respect to the applicability of §48-1645(A) are clearly obiter dictum.

In *Hitt v. Modern Maid, Inc., supra,* in ruling on defendants' motion for summary judgment, the court again noted that T.C.A. §48-1644 bore a "close resemblance to the Federal Securities Laws here under consideration [§17, §10(b) and rule 10b-5]. . . ." Although the court did not mention or apparently take cognizance of the lack of a limitation period within §48-1644, it went on to hold that the one-year limitation of §48-1645 was applicable to plaintiff's §17, Section 10(b) and rule 10b-5 claims, with little explanatory comment. Lastly, in *Clarke v. Wilson,* Civ. C-75-176 (W.D. Tenn. September 19, 1975) the court in agreeing with Judge Wilson in *Hitt* and *Akridge, supra,* held that "Tennessee one-year Blue Sky Law

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69. The court noted that "of the five motions to dismiss only one is supported by a brief." *Akridge, supra* at p 2.

T.C.A. §48-1645A" applied to plaintiff's §10b(b) and rule 10b-5 claims. In response to plaintiff's motion to amend the judgment, the *Clarke* court in a subsequent order acknowledged the existence of Senate Bill 996 which is now designated T.C.A. §48-1652 and provides as follows:

> "Sec. 48-1652. Limitation of civil actions. Civil actions based upon the purchase or sale of any security or upon the solicitation of proxies, whether arising at common law or pursuant to this chapter or pursuant to any federal law creating monetary liability (either specifically or by judicial interpretation) for such purchase, sale or solicitation, *when no other period of limitations is fixed by the law* upon which the action is based, shall be *commenced within two (2) years after the date of such purchase, sale or solicitation.*" (emphasis added).

However, the *Clarke* court went on to cite the foregoing legislation as support for the conclusion that §48-1645(A) is the appropriate limitation period to apply to federal claims based on rule 10b-5.

After a thorough analysis of the statutes and relevant case authority, this court concludes that T.C.A. §48-1645 (A) is neither the applicable nor appropriate limitation period to apply in this case to plaintiffs' federal securities law claims based on §10(b), rule 10b-5 and §17. Close reading of §48-1645(a) reveals that by its terms it is limited in scope and application to "this section." As acknowledged by the Tennessee District Courts, §48-1645 is not the Tennessee statutory provision most closely resembling rule 10b-5. In fact, it is a limited section providing a buyer with the remedy of rescission against various persons participating in an illegal sale of securities. On the other hand, §48-1644 is acknowledged to be the Tennessee Blue Sky Law provision most closely resembling

rule 10b-5. No limitation period is contained therein nor is there any reference in §48-1645(A) to its applicability to civil actions brought pursuant to §48-1644. The enactment of T.C.A. §48-1652 by the Tennessee General Assembly in 1975 clearly indicated the Tennessee legislative intent that there had been no specific statutory provision within the Tennessee Blue Sky Laws which limited civil actions based on §48-1644(B) prior to the enactment of §48-1652 and that Tennessee judicial decisions finding §48-1645(A) the appropriate limitation period for actions based on rule 10b-5, and §17 did not accord with legislative intent. A presumption commonly and properly made is that a legislature in passing a new state statute, acted with full knowledge of the conditions existing at the time of the passage of the act, including judicial decisions relating to the previous law and legislation.[70] Notwithstanding this court's conclusion that §48-1645(A) is inapplicable to actions based on §10(b), rule 10b-5 and §17, any state limitation provision this court determines to apply shall commence running according to federal law. *Sargent v. Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir. 1974); *O'Connell v. Economic Research Analysts, Inc.*, 499 F.2d 994, 996 (5th Cir. 1974). The fact that a state limitation provision contains language specifying when it commences to run, is not determinative or conclusive upon a federal court. *Mooney v. Tallant*, 397 F. Supp. 680, 684 (N.D. Ga. 1975); *Vanderboom v. Sexton*, 422 F.2d 1233, 1240 (8th Cir. 1970). As the court in *Sargent, supra*, stated: ". . . our court-fashioned rule is that a 10b-5 claim accrues when the plaintiff *actually discovers* the alleged fraud." (emphasis added) 492 F.2d at 758. The issue, then, is when did plaintiffs discover the violations of duty hereinabove stated.

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70. 82 C.J.S. *Statutes* §316 p 540 (1953).

As noted above, claims based on §12 and §18 must be brought within one year from actual or constructive discovery. For the reasons fully stated below this court hereby finds and holds plaintiffs actually or constructively discovered the facts giving rise to their claims less than one year before filing the complaint. The converse statement is that plaintiffs did not either actually or constructively discover the facts giving rise to their complaint in excess of one year from the filing of their complaint. The result of this finding and holding is that the court hereby denies defendant's statute of limitations defenses as to plaintiffs' §12 and §18 claims; and even if the one-year limitation of T.C.A. §48-1645(A) is deemed to apply the court hereby finds and holds plaintiffs' §10(b), rule 10b-5 and §17 claims are not time-barred. With respect to defendant's contention that plaintiffs' §14 claims are time barred, Peat contends proof of substantive liability under §14 would "involve liability tests appropriate under §10(b) and Rule 10b-5."[71] Defendant cites no supporting authority for this contention, neither is any authority cited holding any Tennessee limitation period applicable to §14 claims. In the absence of such authority and in view of the court's foregoing determinations, defendant Peat's limitation defense to §14 is held to be without merit and accordingly denied.

(d) *Actual or Constructive Discovery*

Peat contends plaintiffs discovered or should have discovered the facts upon which their claims are based because: (1) the UHM proxy statement[72] corrected the "imprecision" contained in footnote 7(c) to the Standard proxy statement, (2) that the letter dated September 16,

71. Def PEM p 242.

72. Pl Ex 50

1971 from the President and Chairman of the Board of Chadbourn disclosed losses of over 17 million dollars for the fiscal year ended July 31, 1971 and (3) that September 16, 1971, the cut-off date in the settlement of claims against the settling defendants, which settlement was approved by the court is of some significance to this issue.

Although conceding its "imprecision" in footnote 7(c) in the Standard proxy statement, Peat nonetheless cites its correction in the UHM proxy statement mailed to Chadbourn shareholders on or after May 27, 1970. In the 1970 Annual Report of Chadbourn received by plaintiffs and Chadbourn shareholders sometime after November 5, 1970, defendant again committed its "imprecision" in footnote 6(c) of Peat's financial statements contained in the report. It is reasonable to infer, as the court does, that a holder of the $.46-2/3 preferred stock, a former shareholder of Standard common stock at least at the close of 1970, would have viewed the admitted correction of footnote 7(c) in the UHM proxy statement as an aberration among the consistent "imprecisions" contained in footnote 7(c) of the Standard proxy statement and in footnote 6(c) of the 1970 Chadbourn Annual Report. Additionally, considerations of equity preclude Peat from taking advantage of the fact that it may have made a correct description in the UHM proxy statement when it again committed the error in the subsequent Chadbourn Annual Report. Therefore, the court concludes plaintiffs did not actually or constructively discover the bases for their claims against defendant from the UHM proxy statement.

The Chadbourn letter of September 16, 1971, disclosing massive losses for the year ended July 31, 1971, at most could only put plaintiffs on notice of the fact that Chadbourn had suffered substantial losses. It would not be possible for plaintiffs to glean from that letter sufficient

facts to base the claims eventually made by plaintiffs against defendants in their complaints. The court finds and holds that the date of filing plaintiffs' complaint fixes the date when plaintiffs actually knew some or all facts constituting the claims made against defendants in this action. The relevant statutes or judicial decisions require suit to be brought within one year of actual or constructive discovery of the facts constituting the claim or within one year of the time within which the facts constituting the claims should have been discovered. One year prior to the filing of this action is October 12, 1971. The crux of Peat's contentions is that between September 16, 1971 and October 12, 1971, plaintiffs became sufficiently apprised of facts giving rise to their claims. As found and held above, the September 16, 1971 letter was insufficient to so apprise plaintiff Adams. Peat has not cited any other facts or events occurring within that 27-day period to support an inference or conclusion that plaintiffs actually or constructively discovered facts within that period on which to base their claims.

The use of the date September 16, 1971 in the stipulation and settlement of plaintiffs' claims against the settling defendants which was approved by the court, has no factual or legal significance insofar as plaintiffs' actual or constructive knowledge of the basis on which their claims are founded. Defendant's attempt to read more into or to derive more from that date than conscientiously and fairly can be found therein, is misguided and found and held to be without merit.

Upon careful consideration of all the facts and circumstances relevant to actual or constructive discovery by plaintiffs, within the applicable limitation period, of facts on which their claims in this case are based, as shown by the direct evidence and reasonable inferences there-

from, this court is satisfied the evidence does not preponderate in support of defendant's discovery contentions, but on the contrary, preponderates against defendant's contentions; therefore, Peat's discovery contentions should be and hereby are denied in entirety.

2. *§10b (15 U.S.C. §76j (b)) and Rule 10b-5 (17 C.F.R. §240.10b-5)*[73]

Defendant contends that plaintiffs have not presented sufficient evidence and cannot do so as a matter of law, to establish Peat's liability under the standards of rule 10b-5 promulgated pursuant to §10(b). As to the facts which support or preclude a finding of Peat's liability under this section, they are set forth below and con-

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73. §10b (15 U.S.C. §78j (b))

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 (17 C.F.R. §240.10b-5)

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

tained in separate written Findings of Fact and Conclusions of law entered with this decision. Peat contends the following requirements must be proved to establish 10b-5 liability; that:

> (a) Peat, Marwick misrepresented a fact or omitted to state a fact which it was under a duty to disclose and that plaintiffs were not cognizant of that fact;
>
> (b) the fact was material;
>
> (c) Peat, Marwick acted with the requisite degree of culpability;
>
> (d) with respect to the challenged conduct, Peat, Marwick was under a duty which ran to plaintiffs and their interests which they alleged was breached; and
>
> (e) Peat, Marwick's violative conduct caused plaintiffs to purchase or sell securities and
>
> (f) that thereby plaintiffs suffered the loss of which they complain.[74]

Although defendant cites no authority for the foregoing compendium of items requisite for 10b-5 liability, the court will specifically address the following key factors: duty, material misrepresentation, scienter and causation.

(a) *Duty*

Plaintiffs acknowledge there is no privity relationship between Peat and plaintiffs. However, this fact does not preclude a finding of duty to plaintiffs in this case. Peat was engaged by Chadbourn to prepare financial statements which were to be filed with the SEC and included within the proxy statement to be disseminated to all Standard

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74. Def PEM p 170.

shareholders, in seeking their approval of the proposed merger with Chadbourn.[75] Peat had full knowledge of Standard shareholders' reliance upon Peat's representations contained in the financial statements. In such a situation, Peat owed the Standard shareholders, including plaintiffs, the duty to perform and conduct the audit with due care and to observe and comply with applicable auditing standards and principles. At a minimum, that was Peat's duty to plaintiffs. Indeed, Peat indirectly acknowledged its greater responsibilities by charging Chadbourn 125% of Peat's standard rate for its services.[76]

Additionally, an accountant owes a duty to the public to be independent of his client and to report fairly the facts before him.[77]

> "The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the *actual financial condition* of the company." (emphasis added) *Herzfeld v. Laventhol, Kreskstein, Horwath & Horwath,* 378 F. Supp. 112, 122 (S.D.N.Y. 1974)

The court finding a duty existed, it is incumbent upon plaintiffs to prove that Peat breached its duty toward plaintiffs. For reasons stated herein the court finds and holds Peat breached its duty to plaintiffs in several of the particulars specified by plaintiffs.

(b) *Material Misrepresentation*

Plaintiffs allege that Peat failed to perform the Chadbourn audit according to GAAP and GAAS; that Peat

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75. Pl Ex 256.
76. Pl Ex 256.
77. Pl Ex 219, Chapter 1.

failed to properly and adequately describe redemption and dividend restrictions in footnotes to the financial statements; and that Peat failed to disclose in the financial statements or to compel Chadbourn management to disclose gross edp deficiencies. Plaintiffs contend defendant's misrepresentations were both omissive and commissive.

Defendant contends plaintiffs had knowledge of, or access to, the information withheld and misrepresented by Peat, in another part of the Standard proxy statement.[78] The court concludes that in all the circumstances, this was not a meaningful disclosure of facts which Peat deliberately omitted or inaccurately stated, for the reasons below stated.

The only references in the Standard proxy to dividend restrictions are contained in a section entitled "The Chadbourn Common Stock," rather than in the section entitled "Provisions Relating to the $.46-2/3 Preferred Stock of Chadbourn." The terms of the merger did not provide that Standard shareholders would receive Chadbourn common stock in the merger, but only shares of the *$.46-2/3 preferred stock.* Therefore, it is unlikely Standard shareholders would look to the "Common Stock" section for restrictions on preferred stock. Although the preferred stock was convertible into common stock, Standard shareholders would have had little present interest in common stock. Even if there was disclosure in the proxy forepart, only dividend restrictions from the bank loan were noted. There was no disclosure of redemption restrictions or any other matter plaintiffs claim defendant misrepresented or omitted to state.

Defendant contests the effect to be given a decision reported at 7 SEC 689 entitled "*Resources Corporation*

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78. Def PEM pp 178-84.

*International*" regarding an accountant's duty to disclose. Defendant contends the decision requires an accountant to disclose "material facts *relating directly to items which are ordinarily included in a financial statement.*" (emphasis added).[79] The restrictions on dividend payments and redemption of preferred stock contained in the indenture and bank loan agreement, as well as defendant's nonconformity with GAAP and GAAS, were matters "ordinarily included" and reported in financial statements as clearly relevant and material thereto. The edp deficiencies at Chadbourn were of such a pervasive nature and importance that their existence did, or at a minimum, could have significantly affected the entire operation of Chadbourn and would therefore most directly relate to matters contained in the financial statements.

Peat attempts to make a distinction between accounting controls and administrative controls to explain away Peat's reliance on Chadbourn's defective edp system in the 1969 audit. Such distinction is overly technical and ignores the interrelatedness of the concepts in the real world.

No experienced accounting firm can report a company's financial position today and ignore what it may be tomorrow. This is especially true when as in this instance, the accountant has knowledge of adverse information and conditions which obviously may significantly jeopardize the client company's future performance. As noted previously, the independent auditor is under a duty to fairly present the financial position of a company and the "results of operations" in his financial statements.[80] The court finds and holds that defendant misrepresented dividend restrictions contained in the bank loan agreement,

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79. Def PEM p 193.

80. Pl Ex 219, Chapter 1 §1, p 9.

and omitted to state redemption restrictions contained in the indenture and bank loan, dividend restrictions contained in the indeture, gross edp deficiencies at Chadbourn and failed to conduct the 1969 audit in compliance with GAAP and GAAS. The materiality of these misrepresentations and omissions will be discussed below.

Materiality, according to the Sixth Circuit, is a determination to be made upon the facts and circumstances in each particular case. *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969). The test for materiality in the Sixth Circuit is ". . . whether a reasonable man would have attached importance to the undisclosed facts to determine his choice of action in the particular transaction in question." (citation omitted) *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir. 1974) citing *S.E.C. v. Texas Gulf Sulpher Company*, 401 F.2d 833, 849 (2nd Cir. 1968). In *Arber* the Court at page 420 determined that, even with knowledge of the information allegedly withheld, full disclosure would not have "affected the choice of action of a reasonable person in the position of [plaintiffs]." In *Gearheart v. Federal Reserve Bank of Cleveland*, 511 F.2d 353 (6th Cir. 1975) the court concluded that since plaintiffs could not have taken advantage of the withheld information, even had it been disclosed, the omission was not material. In *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968) the court at page 162 cited *List v. Fashion Park, Inc.*, 340 F.2d 457 (2nd Cir. 1965) for the proposition that in nondisclosure cases the "proper test is whether the plaintiff would have been *influenced* to act differently than he did act if the defendant had disclosed to him the undisclosed fact." (citation omitted and emphasis added).

Based upon the foregoing authority the court concludes that the defendant's misrepresentations and omissions, as fully set forth above, were material. This court has no doubt that, had Peat properly described and disclosed in-

formation it incorrectly described or failed to disclose, plaintiffs would have considered it important and would have significantly affected and influenced their investment decisions. This is not to say plaintiffs' ultimate decision to approve the merger might have been otherwise. At this time, it is now impossible to predict with certainty the actions of the Standard shareholders in 1970 had defendant made a full and accurate disclosure in the Standard proxy statement; however, in all reasonable probability, some or all shareholders would not have voted for the merger, at least without important modifications or added conditions.

The court in *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2nd Cir. 1972), said:

> "Rule 10b-5 was intended to prevent those in possession of material inside information from using that information to their own advantage when dealing with others not possessing the same information." 464 F.2d at 887.

An analogous situation is presented here. Defendant possessed material information concerning Chadbourn's shortcomings, which, if disclosed, would have seriously impaired the chances of Standard's shareholders approving the merger. Rather than disclose this information, defendant misrepresented and withheld the adverse information from plaintiffs thereby, in effect, recommending the merger by not reporting the substantially negative aspects of the proposed transaction. The benefit defendant derived from this course of action was to substantially improve the prospect of Chadbourn taking over Standard and thereby improving the prospect of Peat's services being retained by that client in the future.

(c) *Scienter*

In *SEC v. Coffey,* 493 F.2d 1304 (6th Cir. 1974) the Sixth Circuit in discussing the proof burden upon the SEC to obtain injunctive relief stated as follows:

> "In addition to these factors, however, it is essential that the SEC show that [defendant's] inaction was in *'wilful or reckless disregard* for the truth.'" (emphasis added). 493 F.2d at 1314.

As noted by the Sixth Circuit the foregoing statement probably constitutes a minimum standard since "the standards of culpability may be lower in SEC injunctive suits than in private damage actions. . . ." *Coffey, supra* at 1314

The U. S. Supreme Court recently passed on the question of whether proof of scienter is required for 10b-5 liability.[81] In *Ernst & Ernst v. Hochfelder,* 44 U.S.L.W. 4451 (U.S. March 30, 1976) the Supreme Court held that scienter - "intent to deceive, manipulate or defraud" is a necessary element for establishing 10b-5 liability.

Notwithstanding this stringent element of proof, the court concludes that in all the facts and circumstances of this case, scienter on behalf of defendant has been established by a preponderance of the evidence.

On two occasions when it counted most, with full knowledge of the correct term, Peat, deliberately, did not correctly describe the stock which was restricted in the payment of dividends by the bank loan which stock also was of the particular class plaintiffs would receive by the merger. Furthermore, defendant never fully described

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81. The issue as stated by the court was ". . . whether a private cause of action for damages will lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' - intent to deceive, manipulate or defraud." (citation omitted) 44 U.S.L.W. at 4454.

either the dividend restrictions on preferred stock contained in the indenture or the redemption restrictions contained in the indenture and loan agreement. Defendant's agents documented Chadbourn's numerous edp defects at the time of the 1969 audit and approximately one year later some corrections had been made but a considerable number of deficiencies still remained - yet defendant did not feel obliged to report this to plaintiffs. Finally with full knowledge of Chadbourn's deficient edp and other internal weaknesses, defendant conducted its 1969 audit as though Chadbourn was as sound as a dollar used to be - clearly deviating from GAAP, GAAS and the provisions of Peat's own audit manual.[82] The court finds and holds the proof in this case clearly established that, with the knowledge defendant possessed prior to, during and after the 1969 audit compared against the content of the Peat's 1969 Chadbourn financial statements, defendant acted wilfully, with intent to "deceive" and "manipulate" and in "reckless disregard for the truth."

(d) *Causation*

Peat contends plaintiffs must establish dual causation; ". . . *loss causation* - that the misrepresentation or omissions caused the economic harm - and *transaction causation* - that the violations in question caused the [plaintiffs] to engage in the transaction in question." (footnote omitted) *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 - (2nd Cir. 1974) *cert. denied* 421 U.S. 976 (1975).[83]

The court has serious doubts regarding the applicability of the dual causation standard to this case. The language of the court in *Schlick* at pages 380, 384 concern-

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82. Pl Ex 228; Tr 648-50.

83. Def PEM p 210.

ing the applicability of the twofold causation test is clearly dictum.

Despite the court's reservations, "transaction causation" in fact is established by the Standard proxy which caused plaintiffs to "engage in the transaction," [the merger] and the fact of plaintiffs' approving and thereby effecting the merger were the causes of plaintiffs' economic damage thus fulfilling the requirements of "loss causation." The damage causing event for plaintiffs unquestionably was their being induced to approve the merger. Defendant's deliberate misrepresentations and withholding of important information caused plaintiffs to receive substantially less than they had bargained for or as was represented to them.

This court considers the better rule to be that when misrepresentations and omissions are found to be material, as in this case, a court is justified in presuming reliance thereon.

For the reasons above stated, the court finds and holds, absent any contrary credible evidence, causation has been established.

In *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972), the Supreme Court said:

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might* have considered them important in the making of his decision. . . . This obligation to disclose and this withholding of a material fact established the requisite element of causation in fact." (emphasis added and citation omitted) 406 U.S. at 153-54.

Defendant contends that since some Standard shareholders indicated a general reliance upon the recommendation of Standard's management in favor of the merger, that fact precludes a finding of reliance or rebuts any presumption of reliance. The facts of this case establish that defendant misrepresented and primarily omitted to state material facts. Numerous courts have acknowledged the difficulties in proving reliance upon an omitted or withheld material fact and the court declines to require plaintiffs to bear such a burden. *Affiliated Ute, supra, See Blackie v. Barrack,* 524 F.2d 891, 907-08 (9th Cir. 1975). For the foregoing reasons the court declines to alter the presumption of reliance and finding of causation.

(e) *Intervening and Superseding Cause*

In its 255 page post-trial memorandum, defendant devotes two pages to the contention that the statements of Mr. Kramer, General Counsel and a Director of Standard, to the Standard shareholders at the special meeting, representing that there were no restrictions on the payment of dividends on the $.46-2/3 preferred stock constituted an intervening and superseding cause pursuant to §440 of the Restatement (Second) of Torts (1965) which absolves Peat of any liability. However, defendant fails to cite any case applying such concepts to the federal securities claims asserted by plaintiffs.[84] Further, Kramer's statement does not in any way mitigate or absolve defendant of liability under the provisions of securities laws enumerated herein. As noted above in discussing reliance, defendant is not absolved of liability by asserting plaintiffs did not rely on matters Peat intentionally and recklessly misdescribed or withheld and did not disclose to plaintiffs.

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84. Defendant cites *Pearlstein v. Scudder & German,* 346 F.Supp. 443 (SDNY 1972) a case involving the violation of Regulation T of the Federal Reserve's Margin rules. Def PEM p 222.

Even if §440 of the Restatement (Second) of Torts were deemed applicable, §453 thereof provides:

> "It is the exclusive function of the court to declare the existence or non-existence of rules which restrict the actor's responsibility short of making him liable for harm which his negligent conduct is a substantial factor in bringing about, and to determine the circumstances to which such rules are applicable."

Further Restatement provisions negating defendant's contention are §442B and §447.

3. *§12(2) (15 U.S.C. §77l(2))*[85]

Although there is no purchaser-seller privity between plaintiffs and defendant, plaintiffs contend defendant is nonetheless liable under §12(2) because of Peat's involvement in the process of "selling" the merger proposed by Chadbourn.[86] The court rejects plaintiffs' contention and

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85. §12(2) (15 U.S.C. §77l(2))

"Any person who-

. . . .

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

86. Pl Memo pp 51-52.

finds and holds Peat's activities with respect to the Chadbourn merger did not constitute an actual sale sufficient to sustain a determination of §12(2) liability.

As noted below in discussing rule 14a-9 the court finds defendant's misrepresentation and omissions constitute in effect a proxy solicitation. Although Peat's actions did not constitute actualy selling a security, its conduct is akin to aiding and abetting the sale of a security for which §12(2) liability may result. Since the court has found defendant liable under rules 10b-5 and 14a-9 a finding of liability under §12(2) would be superfluous; accordingly, plaintiffs' §12(2) claim is dismissed.

4. *§15 (25 U.S.C. §77o)*[87]

Defendant notes that plaintiffs do not propose a conclusion of law to support a violation of §15.[88] This section provides for liability for "controlling persons." At the trial there was no proof sufficient to show that Peat controlled the actions or behavior of Chadbourn, presumably the entity "controlled." §15 requires liability on behalf of the "controlled" person and this has not been established. For these reasons plaintiffs' claim of defendant's liability under §15 must be and hereby is dismissed.

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87. §15 (15 U.S.C. §77o).

"Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77 l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

88. Def PEM p 225.

5. §17(a) (15 U.S.C. §77 (a))[89]

Defendant notes that plaintiffs failed to propose a conclusion of law with respect to defendant's alleged §17(a) liability.[90] Whether §17(a) provides a private civil action for damages to be implied from its terms is an unanswered question at this time. *Accord, Blue Chip Stamp v. Manor Drug Stores,* 421 U.S. 723 (1975). In any event, §17 is nearly identical to rule 10b-5. Because the court has found plaintiffs' rule 10b-5 claims and proof sufficient to establish liability, a finding or holding whether there is a private implied claim under §17, in the circumstances, would be obiter dictum. Therefore, the court declines to rule on that issue and plaintiffs' §17 claim is dismissed.

6. §14(a) (15 U.S.C. §78(a)) and Rule 14a-9 (17 C.F.R. §240.14a-9)[91]

Plaintiff contends defendant is liable under rule 14a-9 promulgated pursuant to §14. By their very terms §14

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89. §17(a) (15 U.S.C. §77q(a)).

"(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

90. Def PEM p 225.

91. §14(a) (15 U.S.C. §78n(a)).

"(a) It shall be unlawful for any person by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as

(Continued on following page)

and rule 14a-9 condemn misleading statements or omissions involved with the *solicitation* of proxies. While defendant concedes a private right of action exists under §14 it argues there can be no liability under either of these provisions because the inclusion of its financial statements in the Standard proxy statement did not and could not constitute proxy "solicitation."

Defendant cites cases wherein a finding of solicitation is a prerequisite to §14 liability.[92] A thorough review of those cases reveals their factual and procedural dissimi-

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Footnote continued—

the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than exempted security) registered pursuant to section 78 1 of this title."

Rule 14a-9 (17 C.F.R. §240.14a-9).

"(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the demerits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made."

92. *Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963, 970 (2nd Cir. 1969), *cert. denied* 399 U.S. 909 (1970); *Gould v. American Hawaiian Steamship Co.*, 351 F. Supp. 835, 865 (D. Del. 1972); *Robbins v. Banner Industries, Inc.*, 285 F. Supp. 758, 761-62 (S.D.N.Y. 1966). *Fershtman v. Schectman*, [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶92,996 at p. 90,678 (SDNY 1971); *Browning Debenture Holders' Comm. v. DASA Corp.*, No. 72 Civ. 1332 (S.D.N.Y.) filed April 21, 1975.

larity to this case. Defendant contends plaintiffs have not alleged defendant's solicitation of or aiding and abetting the solicitation of the Standard proxy. The pretrial order contains plaintiffs' averment of defendant's §14 and rule 14a-9 liability which the court finds and holds sufficiently established by a preponderance of the evidence.

As repeatedly stated above, prior to preparing Peat's 1969 Chadbourn financial statements, defendant had full knowledge of the terms of the loan agreement, the indenture and the restrictions contained therein, Chadbourn's numerous and significant edp deficiencies, and its own failure to completely adhere to GAAP and GAAS requirements. With such knowledge defendant deliberately chose to misrepresent and omit to state facts which were significantly material to the Standard shareholders. Defendant thereby violated, at a minimum, its duties to remain independent, to fairly present Chadbourn's financial position, and its duty to Standard shareholders and the public and to observe and obey the foregoing professional accounting obligations. By its actions defendant deliberately placed itself in the role of advocacy in not presenting a complete and accurate picture of Chadbourn's financial position and in omitting or inaccurately describing the rights and liabilities pertaining to the Chadbourn $.46-2/3 preferred stock. In short, defendant's financial statements were not neutral but were knowingly and deliberately biased. This constituted advocacy and in practical effect a solicitation of approval for the Chadbourn merger; and therefore aiding and abetting a proxy solicitation by Peat.

For all the foregoing reasons and in view of the rule 10b-5 findings and conclusions, the court hereby finds and holds defendant liable to plaintiffs under rule 14a-9, promulgated pursuant to §14.

7. §18 (*15 U.S.C.* §78r)[93]

Again, as noted by defendant, plaintiffs have proposed no conclusion of law with respect to defendant's alleged §18 liability.[94]

The court agrees with defendant that a showing of individual reliance is a prerequisite to liability under §18.[95] Plaintiffs, having failed to offer evidence of specific individual class member reliance upon defendant's misrepresentations and omissions contained in the financial statements to the Standard proxy statement, liability of defendant has not been established under §18 of the 1934 Act and therefore plaintiffs' claims with respect to this provision are hereby dismissed.

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93. §18 (15 U.S.C. §78r).

"(a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

(b) Every person who becomes liable to make payment under this section may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment.

(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

94. Def PEM p 225.

95. Def DEM p 234.

## D. DAMAGES

The court has found defendant liable to the class under rules 10b-5 and 14a-9 promulgated under §10(b) and §14(a), respectively. Private civil actions under the foregoing rules have been implied by federal courts, of which the Supreme Court stated:

> "Of course we have not hesitated to recognize the power of federal courts to fashion private remedies for securities laws violations when to do so is consistent with the legislative scheme and necessary for the protection of investors as a supplement to enforcement by the Securities and Exchange Commission." (citation omitted) *Rondeau v. Mosinee Paper Corp.*, 442 U.S. 49, 62 (1975).

Having the power to "fashion private remedies" includes the power to fashion the terms of redress. A district court upon finding a violation of federal securities laws, has the full and complete power to administer and adjust remedies to insure complete redress. *J. E. Case Co. v. Borak*, 377 U.S. 426 (1964).

It is axiomatic that the defendant shall not be heard to complain because its conduct precludes mathematical precision in the computation of damages and only requires that a reasonable approximation be applied. *Bird v. Ferry*, 497 F.2d 112, 113 (5th Cir. 1974); *Broffe v. Horton*, 172 F.2d 489, 495 (2nd Cir. 1949).

The Supreme Court has stated:

> "The most elementary conceptions of justice and public policy require that the wrongdoer shall bear the risk of the uncertainty which his own wrong has created." (citation omitted) *Bigelow v. RKO Radio Pictures*,

*Inc.*, 327 U.S. 251, 265 (1946); *Accord, Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 516 F.2d 172, 189 (2nd Cir. 1975).

Dr. Roman Weil, a qualified expert, was retained by plaintiffs to compute the damages he found were caused by defendant based on the below stated assumptions.[96] Defendant did not offer expert testimony on the subject of damages.[97]

The court finds and holds the extensive pretrial research, computations, testimony and opinions of Dr. Weil to be supported by the evidence, and to the extent found reasonable and acceptable to the court in computing damages, his testimony is hereby incorporated into the court's findings and conclusions.

Dr. Weil was asked to assume that Standard Knitting Mills, Inc. shareholders were injured as a result of material misstatements and omissions in Peat's financial statements in the Standard proxy statement of March 27, 1970 which led to the merger of that company into a wholly owned subsidiary of Chadbourn.[98] Upon his exhaustive pretrial analysis and testing of the subject, Dr. Weil concluded that the best method of computing plaintiffs' damages would be to determine what a stockholder retaining one share of Standard common stock would have at the time of trial (11-12-75) if there had been no merger and the stockholder had kept his one share and received the dividends from it until trial time, less the value of the stock plaintiffs actually had at the time of trial.[99] Dr. Weil testified that the value of the one retained share

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96. Tr 911.
97. PTO ¶B, p 58.
98. Tr 918.
99. Tr 921.

of Standard common, if existing and held at the time of trial, would be $15.31; he further testified that the value of the Standard common stock equivalent of what each plaintiff owned at the time of trial, i.e. 1.97 shares of Stanwood common stock, had a value of $2.45 per share, and the difference between the two, i.e. $12.86 per share, Dr. Weil and plaintiffs contend, is the proper measure of monetary damages sustained by plaintiffs.

Following trial, the Jourolmon intervenors moved to separate the determination of liability from damages. Their apparent reason for this motion was to enable counsel for the Jourolmon intervenors to prepare and present a different theory of damages if liability be established.[100] Although the brief in support of the foregoing motion purports to include the subclass, the terms of the motion do not specifically include them. The Rader intervenors, as members of the class, have adopted and approved the position on damages taken by the class representatives.[101] To the extent the Rader intervenors are members of the subclass, their position on damages apparently is that contained in the Jourolmon intervenors' brief.

The damage position asserted by counsel for the subclass is confusing and factually inadequate. For these reasons the court by a memorandum request dated April 29, 1976 directed counsel for the subclass to submit factual data necessary for determination of subclass damages, if any. That information has not been received to date; therefore, the court will suspend ruling on subclass damages until the necessary information is received. Meanwhile, this Memorandum Decision, Findings of Fact and Conclusions of Law and Judgment on all issues, other

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100. Jourolmon Intervenors' Brief pp 51-57.

101. Rader Intervenors' Brief p 1.

than subclass damages, will be forwarded to the Clerk for entry. When determined by the court, the ruling on subclass damages will be included in the judgment.

1. *Class Members' Damages*

The court is satisfied that the appropriate measure of damages in this case is properly based on out of pocket monetary loss; that is, the difference in market value between what plaintiffs gave up, one share of Standard common stock, and what they received in the merger exchange, 1-1/2 shares of Chadbourn $.46-2/3 preferred stock, recently exchanged in the settlement for 1.95 shares of Standard common stock.

Plaintiffs contend Dr. Weil's theory is "essentially" the out of pocket measure of damages.[102] The court, however, does not accept this contention as the theory is applied in Dr. Weil's computations, in arriving at the court's determination of the measure of damages to be awarded plaintiffs in this case.

The before merger value or "what plaintiffs gave up" was determined by Dr. Weil to be $11.00 for each share of Standard common stock prior to the time the merger became effective on April 22, 1970. This figure was reached by comparing the date and price of the last trade recorded as of January 28, 1970 in the Woolsey stock book at $11.00 per share, with Standard's near zero beta indicating Standard's common was a "very stable stock" that "did not change significantly in market price." This comparison was convincing evidence that the $11.00 per share price would not significantly fluctuate between January of 1970 and the date of merger.[103] Other evidence also supports the April 22, 1970 valuation of Standard

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102. Pl Post-argument memo p 22.

103. Tr 960-61.

common stock. In an alternative computation Dr. Weil derived a figure of $10.95 per share for Standard common;[104] the mean of prices paid in prior sales of Standard common was $11.84 per share;[105] Standard shareholders rejecting the merger were paid approximately $11.25 per share;[106] and the $.46-2/3 preferred stock Standard common shareholders received after approving the merger was to be redeemed subject to various conditions and restrictions, at $11.00 per share.[107] Finally, defendant's own records, valued the $.46-2/3 preferred stock at $15.00 per share.[108] For all the foregoing reasons the court hereby finds and holds that at the time of the merger, April 22, 1970, the proper value of one share of Standard common stock was $11.00.

The $11.00 figure also represents the value plaintiffs placed upon the Chadbourn $.46-2/3 preferred stock as "misdescribed" by defendant in the Standard proxy. Because of defendant's misrepresentations and omissions, plaintiffs paid more for the $.46-2/3 preferred than they might have, had defendant made a full and accurate disclosure. To that extent the value of the Chadbourn preferred was "inflated."

The problem presented to the court is to place a value, if possible, upon the information defendant misrepresented and withheld from plaintiffs. Observing the reaction of the stock market to certain information is one method of reaching an objective valuation. In the present case, assuming defendant or another person fully disclosed to the stock market the data this court has found defendant

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104. Tr 962-65.
105. Tr 1247-48.
106. Tr 1344-45.
107. Pl Ex 46, Appendix A to Exhibit A.
108. Pl Ex 18, Pl Reply Memo p 10.

misrepresented and omitted, it is a reasonable inference to find and hold that investors with that information would pay less for Chadbourn's $.46-2/3 preferred than investors without that knowledge. The difference in what market investors would pay before and after such disclosure would represent the market's appraisal of the information defendant withheld and misrepresented. However, there has been no full or accurate disclosure of defendant's omissions and misrepresentations to the stock market, therefore, no stock market fluctuation occurred in the $.46-2/3 preferred stock which the court could measure.

Defendant contends the UHM proxy statement mailed to Chadbourn stockholders on or after May 27, 1970 constituted a full disclosure to which the market could or should have reacted. The court finds this contention to be without merit. The UHM proxy at footnote 7(c) correctly described dividend restrictions in the bank loan agreement as being on "capital" rather than "common" stock. Defendant made no effort to emphasize this correction to the reader of the proxy statement. More importantly, defendant made no other corrections or disclosures in the UHM proxy and consequently defendant's belated correction was not fully effective.

To this date there never has been a full and correct disclosure by Peat, or by anyone else, of the $.46-2/3 preferred stock restrictions, or Chadbourn's edp deficiencies or defendant's inadequate compliance with GAAP and GAAS in the 1969 audit. Furthermore, the reorganization of Chadbourn has entirely abolished the $.46-2/3 preferred stock. Considering all of these extraordinary circumstances, the court finds and holds the proper date for evaluating "what plaintiffs received" should be and hereby is found and held to be October 12, 1972, the day the Adams complaint was filed.

Dr. Weil calculated that on October 12, 1972 plaintiffs' damages were $7.34-1/2 per share plus interest on that amount from October 12, 1972 at 6% per annum to the trial date.[109] As previously stated, the court has found $11.00 per share as the starting figure for assessing plaintiffs' damages, whereas Dr. Weil used $15.31 as his starting figure. Therefore, Dr. Weil's October 12, 1972 damage figure must be reduced by the $4.31 difference between $15.31 and $11.00. This adjustment reduces the measure of plaintiffs' damages as of October 12, 1972 to $3.03-1/2 for each Standard common share, plus interest at the Tennessee legal rate of 6% per annum[110] from the date of filing the Adams complaint to the date of trial, November 10, 1975, and interest shall continue to run at that rate from the trial date until the Judgment entered herewith including taxable costs is satisfied in full. Plaintiffs' damages plus prejudgment interest to time of trial equals $3.63 per the equivalent of one share of Standard common stock.

In awarding plaintiffs' prejudgment interest from the filing of the Adams complaint through the trial date, as a component of compensatory damages, the court has considered all the facts and circumstances of this case, especially defendant's wilful and deliberate behavior with respect to its misrepresentations and omissions. The court concludes the award of interest is proper in this case based on the following authority:

> "An award of prejudgment interest in a case involving violations of the federal securities laws rests within the equitable discretion of the district court to be exercised according to considerations of fairness."

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109. Tr 1339.

110. T.C.A. §47-14-104.

(citation omitted). *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 516 F.2d 172, 191 (2nd Cir. 1975).

The amount above awarded plaintiffs is what the court considers, finds and holds to be a reasonable computation of the out of pocket damages sustained by plaintiffs, as a direct and proximate result of the actions and omissions of Peat upon which the court has found and held defendant liable.

Since the court's computation represents only those damages proximately caused by defendant, the court finds and holds that no deduction from the damage figure, above stated, shall be allowed for any amounts plaintiffs may have received in Chadbourn dividends or in any value, monetary or otherwise, plaintiffs have derived from their stipulation and settlement with the settling defendants. Any benefit Standard shareholders may have received as a result of dividends Chadbourn paid on the $.46-2/3 stock and the negotiated Chadbourn reorganization settlement, were properly a matter to be accounted for between plaintiffs and the settling defendants and should not be credited to Peat, who in no way joined in or contributed anything toward the payment of dividends on Chadbourn's jurior preferred stock or to the corporate reorganization. Having contributed nothing to either dividends or settlement, the court finds and holds that as a wrongdoer, in equity Peat cannot justly claim or be given any credit therefor.

The court has fully reviewed the damage contentions of the Jourolmon intervenors as class members, and concludes therefrom that their contention that defendant is liable to them for Standard's net earnings, as a subsidiary of Chadbourn, for the years 1970-75 in a total of $12,917,394.00 is without merit and is hereby denied. It would be unjust to hold defendant liable on such a basis

and for such an amount, because defendant neither caused such accretions in net earnings nor derived any benefit therefrom. Moreover, the authorities cited in the Jourolmon brief do not support their contentions on the facts found by the court. Therefore, the Jourolmon Intervenors to the extent of their inclusion in the class, shall recover class damages as set forth above.

The court's decision on class member damages shall be limited to those members of the class defined in the court's orders of October 29 and December 21, 1973. Nothing in the foregoing section pertains to the subclass or to its damage recovery, if any.

In summary, it is hereby ORDERED that each plaintiff member of the general class shall have and recover judgment against defendant Peat, Marwick, Mitchell & Co. in the sum of $3.63 per the equivalent of one share of Standard common stock a class member may own, plus interest at 6% per annum from trial time to the entry of Judgment and continuing until the Judgment is fully satisfied.

Counsel for the class, shall prepare, file and serve a complete list of the names and addresses of all class members entitled to recover damages against defendant in accordance with the provisions of this Memorandum Decision; together with all data pertinent thereto including a computation of the total amount of damages for which defendant shall be liable to class members, which total sum when approved by the court shall be entered by the Clerk in the space provided therefor in the Judgment.

Plaintiffs are awarded taxable costs for the items and in the amounts to be determined by the Clerk upon presentation and settlement of plaintiffs' bill of costs, the total amount of which shall be stated by the Clerk in the space provided therefor in the Judgment.

Plaintiffs are hereby also awarded attorneys' fees in an amount to be determined by the court upon a specific statement of fees and expenses incurred herein.[111]

Counsel for the class on or before Monday, June 21, 1976, shall prepare, file and serve a memorandum containing the information on each item above specified; on or before Monday, July 12, 1976, defendant or any party presently in the case may prepare, file and serve a written memorandum of objections, corrections or modifications as to any item included in the data submitted by counsel for the class; on or before Monday July 26, 1976 counsel for the class may file and serve a reply memoranda. All questions presented in the foregoing memoranda shall be deemed submitted for determination by the court upon the memoranda unless oral argument be requested and granted.

IT IS HEREBY SO ORDERED this 19th day of May, 1976.

/s/ George H. Boldt
George H. Boldt
Sr. United States District Judge
WD Wash, Sitting by Designation

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111. See *Wynn Oil v. Purolator Chemical Corp.*, 391 F.Supp. 522 (M.D. Fla. 1974).

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF TENNESSEE
NORTHERN DIVISION
CIVIL ACTION NO. 8052

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,
Plaintiffs,

and

BARRY J. McKEAN, JOHN STEPHEN McKEAN, in his own name and as Trustee for JOHN STEPHEN McKEAN, JR., a minor, and as Trustee for MELODY ANNE McKEAN, a minor, RICHARD S. BAGWELL, LAURA J. BAGWELL, ANNE J. TERRELL, MARY J. FOUST, MYVANWY J. BOYD, NEIL JOUROLMON, ANNE DOSSER JOUROLMON, LOIS JOUROLMON, LEON JOUROLMON, JR., MARTHA P. JOUROLMON, and LEON JOUROLMON, III,
Intervenors,

and

PAUL W. MANKIN, BLENDINE McRAE, CHARLES E. RADER, MAY F. NICHOLS, DELLA EZELL WIDENER, ELIZEBETH COE CARMAN, ILIFF C. FISHER, GRACE F. CHRISMAN, ALBERT HOUSTON FRANKLIN and LUCILLE FRANKLIN,
Intervenors,

-vs-

STANDARD KNITTING MILLS, INC., successor by merger to SKM, INC. and STANDARD KNITTING MILLS, INC., each Tennessee corporation, CHADBOURN, INS., J. E. GETTYS, JACKSON C. KRAMER, HARRY J. NACEY, JR., E. B. RODGERS, J. B. WOOLSEY, J. CHADBOURN BOLLES, THOMAS N. ROBOZ, CURT SEIFART, E. M. HICKS, JR., J. W. JOHNSTON and PEAT, MARWICK, MITCHELL & CO.,
Defendants.

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

Upon close examination and full consideration of the memoranda and argument of counsel as well as the exhibits and testimony adduced at trial, the court hereby enters the following Findings of Fact and Conclusions of Law, by this reference including herein all Findings of Fact and Conclusions of Law specifically stated or plainly indicated by the court in the Memorandum Decision entered this date.

Defendant has proposed 225 Findings of Fact and 24 Conclusions of Law, each of which the court has fully reviewed. Some of defendant's proposed Findings have been incorporated into the court's Findings, with modifications. The remainder have been excluded either because they were duplicitous, unnecessary or irrelevant to rulings on th key issues, contained argumentative language or drew inferences from the evidence which the court finds unreasonable or inconsistent with inferences acceptable in the opinion of the court. The above comments are equally applicable to a number of plaintiffs' proposed Findings and Conclusions.

Only fact findings that appear to directly and significantly present issues in this case are included herein or in the Summary of Findings of Fact or findings stated elsewhere in the Memorandum Decision. As stated above, the Memorandum Decision is incorporated herein by reference.

To the extent that a Finding of Fact herein may be, in whole or in part, a Conclusion of Law; or vice versa, it shall be considered to be included in either or both categories.

## FINDINGS OF FACT

(1) Jurisdiction is vested in this court by virtue of Section 22(a) of the Securities Act of 1933, and Section 27 of the Securities Exchange Act of 1934.

## THE LOAN AGREEMENT

(2) Chadbourn entered into a loan agreement dated as of August 2, 1969 between itself and the North Carolina National Bank, The First National Bank of Boston and The First National Bank of Atlanta, in connection with a $6,-000,000 loan.[1]

(3) At the time of preparing financial statements for inclusion into the Standard proxy statement, defendant was fully aware of the restrictive provisions contained in the loan agreement referred to in (2).

## THE INDENTURE

(4) Under date of March 15, 1969, and pursuant to the issuance and public sale of $12,631,000 of 6-1/2% convertible subordinated debentures due March 15, 1969, Chadbourn entered into an indenture with the First National City Bank as Trustee.[2]

(5) From the time the debentures referred to in (4) were sold, on or about March 15, 1969, defendant was fully familiar with the restrictive covenants contained in the indenture.

(6) From August 2, 1969 through April 22, 1970, the date of the merger, the above described bank loan and debentures were outstanding obligations of Chadbourn in the total amount of approximately 18.5 million dollars.[3]

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1. Pl Ex 3.
2. Pl Ex 1.
3. Pl Ex 76 pp F-5, 10, 11.

## THE MERGER

(7) Standard Knitting Mills, Inc., (Standard) a Tennessee corporation, incorporated in 1900, has operated as a manufacturer of knitwear in Knoxville, continuously from its founding to the present time.

(8) Prior to the merger, Standard Knitting Mills, Inc. was a corporation, the stock of which was publicly owned by approximately 566 persons.[4]

(9) On July 28, 1969, Standard management entered into a merger agreement with Chadbourn, Inc. and on October 13, 1969 Standard management entered into an amended agreement of merger.[5]

(10) Both agreements required an affirmative vote of a majority of the holders of Standard's outstanding common stock, voting as a class, and an affirmative vote of the holders of a majority of Standard's preferred stock, voting as a class.[6]

(11) Both agreements provided that the merger of Standard and Chadbourn would be accomplished by the following steps:

(a) Chadbourn would transfer to its wholly-owned subsidiary, SKM, 995,754 shares of $.46-2/3 cumulated convertible preferred stock, $10 par value of Chadbourn, and 63,174 shares of common stock, $1 par value of Chadbourn.

(b) Standard would merge into SKM (the surviving company, which would adopt the Standard name). Each of the outstanding shares of Standard's preferred stock would automatically be converted

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4. Pl Ex 349.
5. Pl Ex 67, 68.
6. Pl Ex 67, 68.

into and become 11 shares of the $.46-2/3 cumulative convertible preferred $10 par stock of Chadbourn (hereinafter referred to as the $.46-2/3 preferred stock), and each of the shares of Chadbourn's common stock would automatically be converted into and become 1-1/2 shares of the $.46-2/3 preferred stock.

(c) In addition, the Agreement provided for issuance of Chadbourn common stock to the holders of the $.46-23 preferred stock in the event, after the merger, Standard's earnings exceeded certain specified requirements.[7]

(12) On April 22, 1970, the Standard stockholders voted in favor of the merger, which was consummated in accordance with the merger agreement dated October 13, 1969. Plaintiff class received 995,754 shares of newly created $.46-2/3 preferred stock in exchange for its shares of Standard Knitting Mills, Inc.[8]

(13) The $.46-2/3 preferred stock of Chadbourn required Chadbourn, when and as declared, to pay quarterly dividends totalling 46-2/3 cents each year for each such share of stock.[9]

(14) The rights and liabilities of the $.46-2/3 preferred stock were ineffectively described in the text of the Standard proxy statement and were set forth in more detail in Appendix A to the Standard proxy statement dated March 27, 1970, which was used to solicit votes in favor of the merger.[10]

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7. Pl Ex 67, 68.
8. Pl Ex 113, 114, 123, 77.
9. Pl Ex 76 App. A.
10. Pl Ex 76.

*Defendant Peat, Marwick, Mitchell & Co. (Peat):*

(15) Peat is a national firm of certified public accountants which was engaged by Chadbourn to prepare financial statements for inclusion in the Standard proxy statement, which Peat fully acknowledges.[11]

(16) Peat began preparing the Chadbourn financial statements and notes thereto, for the period ended August 2, 1969, sometime in June or July of 1969.[12]

(17) Martin Kehoe was the partner in charge of the account; Hugh Freeze was the manager of the audit; and Gerald Broome was the senior on the audit.

(18) All or part of Peat's August 2, 1969 financial statements were included in the Continental Strategics, Standard, United Hosiery Mills proxy statements and in the 1970 Annual Report for Chadbourn.[13]

FOOTNOTE 7

(19) The Standard proxy statement was mailed to Standard stockholders on March 27, 1970. Footnote 7 dealing with Chadbourn's long-term debt, omitted to disclose provisions in the loan agreement and in the indenture restricting dividend payments to and redemption of the $.46-2/3 preferred stock.[14]

(20) With full knowledge of the correct description, Peat incorrectly described Chadbourn junior preferred dividend restrictions contained in the bank loan agreement,

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11. Pl Ex 256; Tr. 75, 77, 80, 83.
12. Tr 2175, 2176.
13. Pl Ex 51, 76, 50, 9.
14. Tr 219.

both in the Standard proxy statement and in the 1970 Annual Report for Chadbourn.[15]

(21) Although defendant corrected the description of dividend restrictions in the United Hosiery Mills (UHM) proxy statement, such correction was an insufficient disclosure of dividend restrictions for notice purposes because:

(a) Defendant did not highlight or otherwise call the correction to the attention of plaintiffs.[16]

(b) Defendant's financial statements, except for an unaudited stub period, were essentially the same as the statements contained in the Standard proxy statement.[17]

(c) The merger had been fully consummated by the time plaintiff stockholders received the UHM proxy and the principal purpose of the UHM proxy was to encourage shareholder approval of a loan and option agreement with three companies other than Chadbourn; in these circumstances, there would be no reason for plaintiffs to critically analyze Chadbourn's financial condition or defendant's footnotes.

(d) Whatever possible revelations could be attributed to the UHM proxy were negated by defendant again committing its footnote error in the 1970 Annual Report for Chadbourn.[18]

(22) None of the footnotes to defendant's financial statements included in the Continental Strategics, Standard and UHM proxy statements or in the 1970 Annual Report for Chadbourn disclosed the restrictions in the loan agreement and indenture regarding redemption of stock of *any*

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15. Pl Ex 76 n. 7(c); 9 n. 6(c).
16. Tr 136-38; 359.
17. Tr 249, 252, 359-61.
18. Pl Ex 9 n. 6(c).

class or to the indenture provisions restricting payment of dividends.[19]

(23) Although the forepart of the Standard proxy contained a description of dividend restrictions contained in the loan agreement there was no effective disclosure since the description was contained in a section entitled "The Chadbourn Common Stock" which stock plaintiffs would *not* receive, rather than in the proper section entitled "Provisions Relating to the $.46-2/3 Preferred Stock of Chadbourn" which stock plaintiffs *would* receive.[20]

(24) At no time prior to Chadbourn's 1971 Annual Report was there disclosure of restrictions contained in the indenture or in the loan agreement on the redemption of stock by Chadbourn.[21]

(25) In contending redemption restrictions in the loan agreement would expire prior to Chadbourn's obligation to redeem the $.46-2/3 preferred stock, Peat improperly assumed timely loan payment or renegotiation thereof prior to the due date.[22]

(26) The court finds the restrictive provisions in the indenture did apply to Chadbourn for the following reasons:

(a) It is a reasonable interpretation of the restrictive provisions of the indenture, which the court concludes is correct and proper under all the circumstances.

(b) Defendant's witness Weston admitted differing interpretations of the indenture restrictions were possible.

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19. Pl Ex 51, 76, 50, 9.
20. Tr 264-65.
21. Tr 157-58.
22. Tr 1583.

(c) Following a dispute with Chadbourn's counsel, Peat acquiesced in permitting counsel's draft of indenture restrictions to appear in the 1971-73 annual reports of Chadbourn, which draft distinctly specified dividend payment and stock redemption restrictions on Chadbourn.[23]

(d) The court finds the testimony of Martin Kehoe incredible with respect to this issue.

(27) Peat's incorrect footnote and omission of the redemption and dividend restrictions, rendered defendant's opinions a violation of duty to plaintiffs in that Peat's audit was not performed in accordance with generally accepted auditing standards, as certified to by defendant in all the proxy statements and in Chadbourn's Annual Reports.

(28) In connection with its services performed in auditing Chadbourn's financial statements and in preparing footnote 7 thereto, Peat at all times after July 24, 1969 knew the intended use and users of the Chadbourn financial statements of August 2, 1969 and accompanying footnotes Peat prepared were for inclusion in the proxy statement to be sent to Standard shareholders in soliciting their votes in connection with the above described merger between Standard Knitting Mills, Inc. and Chadbourn.

(29) The Standard Knitting Mills shareholders were users of the Chadbourn financial statements bearing defendant's certificate, in reviewing defendant's statements for the purpose of deciding whether or not to commit the value of their Standard shares to the merger with Chadbourn.[24]

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23. Tr 1583.
24. Tr 249.

(30) Defendant had a direct duty to consider the needs of the specific users of the information certified by Peat, namely the Standard Knitting Mills shareholders contemplating whether to approve the proposed merger.[25]

(31) Defendant failed to act in accordance with its duty toward plaintiffs as specific users, by failing to fully and accurately disclose in the financial statements dividend payment and stock redemption restrictions contained in the loan agreement and the indenture; that is, the very type of information defendant knew was vital to the financial interest of those users.[26]

(32) The restrictions in the loan agreement relating to payment of dividends did apply directly to the preferred stock of Chadbourn, including the $.46-2/3 preferred stock which, upon approval of the merger, would be received by the Standard shareholders.[27]

(33) The restrictions in the loan agreement relating to redemption of stock did apply to the preferred stock of Chadbourn including the $.46-2/3 stock to be received by the Standard shareholders upon approval of the merger.[28]

(34) The restrictions in the bond indenture relating to payment of dividends did apply to preferred stock of Chadbourn including the $.46-2/3 preferred stock to be received by the Standard shareholders upon approval of the merger.[29]

(35) The restrictions in the bond indenture relating to the redemption of stock by Chadbourn applied to the

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25. Tr 249.
26. Tr 218, 1558, 1559.
27. Tr 224, 314, 328-33.
28. Tr 224, 314-17, 328-32.
29. Tr 224, 314-17, 407-09, 416, 328-32.

preferred stock of Chadbourn including the $.46-2/3 preferred stock to be received by the Standard shareholders upon approval of the merger.[30]

(36) Footnote 7(c) to the Standard proxy statement wherein defendant described loan agreement dividend restrictions as applying to "common" stock, clearly was false and misleading.[31]

(37) The misdescription in footnote 7(c) was material; it was a matter about which a prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable Standard shareholder in the process of deciding how to vote on the merger proposal and; it had a significant propensity to affect the merger voting process.[32]

(38) Defendant's failure to correctly describe dividend restrictions on preferred stock contained in the loan agreement was a material omission rendering footnote 7(c) false and misleading.[33]

(39) Defendant's failure to disclose in footnote 7(c) redemption restrictions on the $.46-2/3 preferred stock contained in the loan agreement was a material omission which rendered footnote 7(c) false and misleading.[34]

(40) Omitting to disclose the redemption restrictions was a matter about which a prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable Standard shareholder in the process of deciding how to vote on the merger

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30. Tr 224, 314-17, 323-32, 407-09, 416, 2330-36.
31. Tr 332-33, 314, 317, 328-32.
32. Tr 230-36, 302-03, 314-17, 328-32.
33. Tr 230-36, 314-17, 328-32.
34. Tr 230-36, 314-17, 328-32.

proposal and; it had a significant propensity to affect the merger voting process.[35]

(41) Defendant's failure to disclose in footnote 7(d) the bond indenture restrictions relating to the payment of dividends on the $.46-2/3 preferred stock was a material omission which rendered the footnote false and misleading.[36]

(42) Failing to disclose the dividend restrictions contained in the indenture was a matter about which a prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable Standard shareholder in the process of deciding how to vote on the merger proposal and; it had a significant propensity to affect the merger voting process.[37]

(43) Defendant's failure to disclose in footnote 7(d) the indenture restrictions relating to the redemption of the $.46-2/3 preferred stock was a material omission which rendered footnote 7(d) false and misleading.[38]

(44) Failing to disclose the redemption restrictions contained in the indenture was a matter about which a prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable Standard shareholder in the process of deciding how to vote on the merger proposal and; it had a significant propensity to affect the merger voting process.[39]

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35. Tr 230-36, 314-17, 328-32.
36. Tr 230-36, 314-17, 407-09, 416.
37. Tr 230-36, 302-03, 314-17, 328-32, 407-09, 416, 422-24.
38. Tr 230-36, 314-17, 328-32, 407-09, 416, 422-24.
39. Tr 230-36, 302-03, 314-17, 328-32.

## CHADBOURN ELECTRONIC DATA PROCESSING (EDP) DEFICIENCIES

(45) As an integral part of defendant's regular examination of Chadbourn for the year ending August 2, 1969, Peat reviewed computer procedures and systems controls at Chadbourn.[40]

(46) The examination referred to in (45) was performed by Mr. Thomas Marston, a Peat employee, as part of what was described as a four-day overview of the data processing department.[41]

(47) Professor Rittenberg who reviewed Marston's work papers and other documents and records, testified to and the court finds and holds, there were numerous deficiencies in internal control primarily regarding poor input and lack of controls.[42]

(48) Chadbourn, as admitted by its edp manager, Dick Dalton, experienced excessive keypunch man-hours to prepare data for computer input, edit programs were not effectively detecting all errors and the data comprising the gross profit report and the ticket listing were not edited.[43]

(49) Defendant's test of the ticket listing, as explained by Brasington was insufficient to verify its accuracy.[44]

(50) From the letters sent by Peat to Chadbourn, the Marston working papers, the Kurt Salmon report and the evidence that Chadbourn had a series of gross deficiencies

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40. P1 Ex 164.
41. Tr 459.
42. Tr 428-656.
43. Tr 509-10.
44. Tr 1739, 1746-1801.

in its edp system, Peat had full knowledge of Chadbourn's serious edp problems and their adverse impact on internal control, production, production planning, production accuracy, shipping, invoicing and accounts receivable control; nevertheless, Peat failed to disclose any of said data processing problems in connection with its 1969 audit to anyone other than Chadbourn management.[45]

(51) The court finds and holds that Peat's failure to disclose, in a footnote or elsewhere in its October 21, 1969 opinion, Chadbourn's edp problems was a material omission of which Peat had full knowledge.

(52) Peat's failure to disclose Chadbourn's gross edp deficiencies rendered defendant's financial statements false and misleading and the omission related to a matter about which an average, prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable Standard shareholder who was in the process of deciding how to vote on the proposed merger; and it would have a significant propensity to affect the merger voting process.

(53) Peat had a duty to the Standard stockholders to disclose the material facts it omitted and to fairly state the information concerning the data processing problems and Peat's failure to do so constitutes a breach of its duty of disclosure.

## GENERALLY ACCEPTED AUDITING PRINCIPLES AND STANDARDS (GAAP and GAAS)

(54) The accounting profession in the United States is guided by certain GAAP and GAAS which are promulgated by the American Institute of Certified Public Accountants.

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45. Pl Ex 164, 165, 168, 174, 178, 311.

(55) In 1959, Statement on Auditing Procedure (SAP) No. 33 was in effect.[46]

(56) The second standard of field work provides there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.[47]

(57) Peat's own internal audit manuals highlight the need to examine internal control.[48]

(58) Various management letters from Peat to Chadbourn indicated numerous weaknesses in internal control.[49]

(59) Notwithstanding the weaknesses developed through various internal control questionaires, comments in the Management Comment Letters, and the content of Peat's work papers, Peat relied on the system of internal control, particularly in the areas of inventory work forward, inventory valuation, and confirmation of accounts receivable.[50]

(60) Although Peat's audit manual also notes the need for observing and taking inventory at year end when weaknesses in internal control are disclosed, Peat observed Chadbourn's inventory prior to year end, primarily for the convenience of the client, and relied on Chadbourn's internal control to up-date the year end inventory.[51]

(61) Peat's auditing procedures in connection with its audit of Chadbourn for the year ended August 2, 1969

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46. Pl Ex 219; Tr 220.
47. Pl Ex 219.
48. Tr 648-50.
49. Pl Ex 164, 165, 166.
50. Tr 444-551, 631, 632.
51. Tr 644, 645, 1879.

unjustifiably and improperly assumed that Chadbourn had a sufficient system of internal control.

(62) Peat knew there were pronounced weaknesses in the area of internal control dealing with inventory, production, order entry system, cost control, data processing and accounts receivable; nevertheless, Peat relied upon Chadbourn's system of internal control in connection with its 1969 audit of Chadbourn.

(63) Reliance upon an unsound system of internal control by an auditor constitutes a violation of GAAS, particularly the second standard of field work.

(64) The third general standard provides: "Due professional care is to be exercised in the performance of the examination and in the preparation of the report."[52]

(65) There are numerous deficiencies in defendant's working papers, each of which constitutes a failure by Peat to exercise due professional care.

(66) Where the work papers stated that audit procedures were performed by checking a questionnaire, the work papers failed to document that such audit procedures were actually performed.

(67) Four working papers selected by defendant's witness William Brasington to support Peat's contention that proper tests of the physical inventory listing were made, in fact, proved that proper tests were not made.[53]

(68) Less than 5% of the inventory was tested into the data processing ticket listing; a substantial portion of that which was tested indicated discrepancies, yet Peat deliberately accepted its accuracy.[54]

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52. Pl Ex 219; Tr 640-42.
53. Tr 1758, 1796.
54. Tr 1785.

(69) No test was made of the Standard cost build-up which was documented in the working papers.[55]

(70) In connection with valuing the inventory, no test was made considering sizes or color.[56]

(71) Peat's failure to consider color in valuing the inventory is particularly meaningful since redyeing of obsolete colors was part of the business of Chadbourn.[57]

(72) Peat improperly accepted the Company's representation as to style without auditing or testing.[58]

(73) Accordingly, the court finds that Peat in the particulars above stated, failed to perform its 1969 audit of Chadbourn by using due professional care and therefore violated the third general standard.

(74) The third general standard is also applicable to footnote 7(c) in the Standard proxy statement, wherein the incorrect word "common" was deliberately used instead of the correct word "capital," in referring to the restrictions on the payment of dividends.

(75) With further respect to footnote 7(c) defendant violated Statement on Auditing Procedure (SAP) No. 41 by not making any effort to correct the error contained therein when Peat had full knowledge of the correct description and defendant's error was specifically brought to its attention contemporaneously with the mailing of the Standard proxy statement and prior to the Standard shareholder meeting.[59]

(76) The third standard of field work provides that sufficient evidential matter is to be obtained through in-

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55. Tr 621, 1813, 1814, 2316.
56. Tr 2320, 1718, 2067, 2220.
57. Tr 1780.
58. Tr 568, 575, 582, 850, 2220.
59. P1 Ex 217, 43; Tr 119-20.

spection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.[60]

(77) Peat's work papers disclose that often the evidential matter that was discovered was contradictory, insufficient, confirmations did not tend to confirm, certain tests were performed at improper times, and the working papers as a whole clearly establish a failure to conform to the third standard of field work.

(78) The inventory working papers do not cite the performance of tests such as standard cost buildup and testing of gross profit report and indicate that the inventory was taken at a date other than year end, a condition that would ordinarily be permissible only when a strong system of internal control exists, which was not the case at Chadbourn during the relevant time period.

(79) Entries in an auditor's work papers are the best evidence of performance of matters recorded therein.

(80) Peat confirmed accounts receivable on two different dates but failed to reconcile the confirmations received on the two dates.[61]

(81) When Chadbourn converted from standard to actual costs, the costs of the company as a whole were utilized rather than the cost centers of individual plants. Failure to apply the standard costs on an individual plant basis, constitutes a departure from GAAP.[62]

(82) Peat admitted by the testimony of Brasington and Quigley that no review of the standard cost system was documented in the working papers.[63]

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60. P1 Ex 219.
61. Tr 631-32.
62. Tr 612-13.
63. Tr 821, 1813-14, 2315.

(83) Where the standard costs were relied on in determining actual costs, it was mandatory from the standpoint of GAAS that Peat review and audit the standard cost system itself, which Peat did not do.[64]

(84) Peat's acceptance of the procedure whereby the average of all the plants were averaged to determine an overall standard cost variance constituted a departure from GAAS.

(85) Peat assigned Luther Barrier, an inexperienced junior, to physically observe the inventory at the griege storage area of Plant 4.[65]

(86) Of approximately 1,000 to 1,500 bins, it was *estimated* by Peat that approximately one hundred bins had been tested by Barrier because the working papers failed to disclose how many bins were actually tested.[66]

(87) Barrier reported on the actual testing of some forty bins in which discrepancies were found.[67]

(88) Professor Rittenberg testified that over 50% of the bins tested disclosed errors and indicated that additional testing should have been undertaken.[68]

(89) Although Broome noted the discrepancies in bin tests in Barrier's report, Broome never checked on whether the bin discrepancies were corrected and Peat's work papers do not disclose correction or reconciliation.[69]

(90) Inventory adjustments from the physical inventory on July 5, 1969 to the year end inventory on August

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64. Tr 612.
65. Tr 1904-05.
66. Tr 2042.
67. Tr 2043.
68. Tr 580.
69. Tr 2045.

2, 1969 were based upon untested and unreliable data and resulted from the application of reports generated by Chadbourn's edp department based upon Chadbourn's unreliable system of internal control.[70]

(91) Defendant's failure to test the reports referred to in (90), in view of its knowledge of the numerous and serious edp weaknesses of the Chadbourn system constituted a departure by Peat from GAAS.[71]

(92) Peat did not have sufficient evidence to form an opinion on whether inventory was valued in accordance with GAAP in the following particulars:

(a) Peat failed to consider obsolescence factors and slow moving box stock.[72]

(b) Peat tested an insufficient quantity of subsequent sales.[73]

(c) Peat relied upon inadequate and untested data to confirm the selling price during the inventory work forward and subsequent period.[74]

(d) Peat performed insufficient cut off tests.[75]

(e) Peat accepted client prepared records without any testing of such records.[76]

(93) Peat failed to adequately test market value in the August 2, 1969 inventory which constituted a violation of GAAS.[77]

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70. Tr 515, 550, 586, 590, 620, 821.
71. Tr 547-52.
72. Tr 579-80, 618, 1783.
73. Tr 618, 832-44.
74. Tr 589, 828-31, 1824, 2059.
75. Tr 573.
76. Tr 604-08.
77. Tr 821.

(94) Peat's reliance on the results of the interim test of sales which were unreliable and inconclusive constitutes a departure from GAAS.[78]

(95) Peat's opinion dated October 21, 1969 in the Standard proxy statement, was false and misleading in that it represented that Peat had performed its audit of Chadbourn in accordance with GAAS and GAAP.

(96) Peat's failure to disclose in its October 21, 1969 opinion that the 1969 Chadbourn audit was not made in accordance with GAAS and GAAP and its failure to qualify its opinion according to the facts, was a material omission and rendered its statement false and misleading.

(97) Peat's material omission referred to in (96) was a matter about which an average, prudent investor ought reasonably to have been informed; it would have been considered important by a reasonable stockholder of Standard who was in the process of deciding how to vote on the proposed merger; and it would have a significant propensity to affect the voting process concerning the merger proposal.

(98) Defendant had a duty to Standard shareholders either to disclose the material facts Peat omitted and to require that the information provided in Chadbourn's financial statements be complete and accurate, or to qualify its opinion accordingly; Peat did neither.

(99) Throughout Peat's 1969 audit of Chadbourn and the preparation of its opinion of October 21, 1969, defendant knew Chadbourn's financial statements were to be used in Standard's proxy statement of March 27, 1970 and that the Standard shareholders would be users of said financial statements and would rely thereon in making their decision regarding the merger proposal.

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78. Tr 535.

(100) Peat's failure to consider the needs of the Standard stockholders from the standpoint of financial statement disclosure, constituted a violation of GAAP.

(101) Both regulation S-X and Accounting Series Release No. 35, dated September 3, 1942, were violated by Peat in connection with its non-disclosure of the restriction on the payment of preferred stock dividends, the failure to disclose Chadbourn's edp problems and the failure to comply with GAAS and GAAP.

(102) The misrepresentation and omissions of defendant which have been fully documented in the Memorandum Decision and herein, were committed or omitted by Peat wilfully, deliberately with intent to deceive and manipulate and with reckless disregard for the truth.

Based on the foregoing Findings of Fact, the court makes the following:

## CONCLUSIONS OF LAW

1. This court has jurisdiction over the subject matter of this action pursuant to §§12(2), 15 and 17 of the Securities Act of 1933, and §§10(b), 14 and 18 of the Securities and Exchange Act of 1934, as well as rules 10b-5 and 14a-9 of the Securities and Exchange Commission promulgated thereunder.

2. Defendant is subject to the jurisdiction of this court.

3. The merger of Standard Knitting Mills, Inc. into SKM, Inc. was a transaction involving the sale of securities as those terms are construed in the Securities Act of 1933 and the Securities and Exchange Act of 1934 and applicable regulations, rulings and releases promulgated thereunder.

4. The proxy solicitation of March 27, 1970 was an essential link in the merger transaction.

5. For the reasons stated in the Memorandum Decision of the court and the court's Findings of Fact, defendant is liable to plaintiffs under rule 10b-5 (17 C.F.R. §240.10b-5) promulgated pursuant to §10(b) (15 U.S.C. §78j(b)) because (a) defendant misrepresented a fact and omitted to state facts which rendered defendant's statements false and misleading; (b) the facts misrepresented and omitted were material; (c) Peat's actions were wilful and intended to deceive and manipulate, and in reckless disregard for the truth; (d) Peat clearly breached its duty toward members of the class and violated a number of GAAS and GAAP; (e) defendant's actions were, in fact, the proximate cause of plaintiffs' approval of the merger and the damage proximately caused thereby; and pursuant to the above specified violations, defendant hereby is found and held liable to plaintiffs for damages. *Ernst & Ernst v. Hochfelder,* 44 U.S.L.W. 4451 (U.S. March 30, 1976); *Affiliated Ute Citizens v. U.S.,* 406 U.S. 128 (1972); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 353 F. Supp. 264 (S.D.N.Y. 1972); *Gould v. American-Hawaiian Steamship Co.,* 351 F. Supp. 852 (D. Del. 1972); *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970); *J. I. Case Co. v. Borak,* 377 U.S. 426 (1964).

6. With respect to rule 14a-9 (17 C.F.R. §240.14a-9) promulgated pursuant to §14(a) (15 U.S.C. §78n(a)) defendant is liable to plaintiffs for damages by reason of the above stated findings and conclusions establishing defendant's rule 10b-5 liability, and by reason of the additional fact that defendant's non-neutral financial statements in the Standard proxy were material misrepresentations and omissions knowingly and wilfully included in the proxy which constituted a solicitation of the Standard proxy by defendant for which liability is established.

7. Defendant violated Regulation S-X, Accounting Series Release No. 35, Statements on Auditing Procedure 33 and 41, the second standard of field work, the second general standard, the third general standard, and the third standard of field work.

8. Plaintiffs and the class members shall not recover under §12(2) (15 U.S.C. §77 l (2)) because defendant did not actually "sell" a security.

9. Plaintiffs and the class shall not recover under §15 (15 U.S.C. §77o) for failure to prove that defendant controlled a person, or an entity, or to identify a controlled party.

10. Plaintiffs and the class shall not recover under §17(a) (15 U.S.C. §77q(a)) because defendant's liability under rule 10b-5 has been established by the court, and a holding by this court, pro or con, on defendant's liability under 17(a) would be obiter dictum.

11. Plaintiffs and the class shall not recover under §18 (15 U.S.C. §78r) because under that statute individual reliance must be, and in this case has not been, proven.

12. Plaintiffs shall recover damages in the amount of the difference in value of one share of Standard common stock at the date of the merger [$11.00] and the value of an equivalent amount of Chadbourn $.46-2/3 preferred stock at the time of commencement of this suit, [$7.96-1/2] plus interest at 6% per annum from the filing of the Adams complaint, October 12, 1972, to the time of trial, November 10, 1975, which amounts to a total of $3.63 for the equivalent of one share of Standard common stock.

13. Plaintiffs are entitled to recover damages and prejudgment interest, included in the amount above spe-

cified, plus interest at the rate of 6% per annum from trial time, November 10, 1975, until the date this Judgment is entered and thereafter until the judgment is satisfied in full.

14. Taxable costs shall be awarded plaintiffs in an amount to be determined by the Clerk upon settlement and approval of plaintiffs' cost bill.

15. Attorneys' fees shall be awarded to plaintiffs in an amount to be determined by the court.

DATED this 19th day of May, 1976.

/s/ George H. Boldt
George H. Boldt
Sr. United States District Judge
WD Wash - Sitting by Designation

Nos. 78-1111/2
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,
Plaintiffs-Appellees,

BARRY J. McKEAN, et al., PAUL W. MANKIN, et al.,
Intervenors-Appellees,

v.

STANDARD KNITTING MILLS, INC., et al.,
Defendants,

PEAT, MARWICK, MITCHELL and COMPANY,
Defendant-Appellant.

Before: WEICK, ENGEL and MERRITT, Circuit Judges.

**ORDER DENYING PETITION FOR REHEARING**

(Filed July 23, 1980)

A majority of the Court having not voted in favor of an en banc rehearing, the petition for rehearing has been referred to the hearing panel for disposition.

Upon consideration, it is ORDERED that the petition for rehearing be and hereby is denied.

ENTERED BY ORDER OF THE COURT
/s/ John P. Hehman
Clerk

WEICK, Circuit Judge, Dissenting:

I respectfully dissent from the order denying en banc consideration of the petition for rehearing and from the denial of the petition for rehearing.

The Securities and Exchange Commission, the government agency in charge of and primarily responsible for administering the federal securities laws, including the Securities Exchange Act of 1934, has filed in this court, Memoranda, as amicus curiae, in support of the petition for rehearing en banc pointing out that the erroneous decision of the panel "will have serious adverse effects on both the enforcement of the federal securities laws by the Commission and on the maintenance of private rights of action under these laws."

On Page 3 of its Memorandum, the Commission states:

> The Commission submits that the panel decision is premised upon two significant misperceptions concerning the culpability required to be shown in determining the liability of the accounting firm here under the federal securities laws:
>
> 1. The panel erred in defining "scienter" as meaning "a *desire* to deceive, defraud or manipulate" and in searching the record for evidence of a "motive for deception."
>
> 2. The panel erred in concluding that a showing of scienter was required as a prerequisite to recovery of damages in a private action under Section 14(a) of the Securities Exchange Act and Rule 14a-19 thereunder.
>
> The Securities and Exchange Commission, the agency primarily responsible for administering the federal securities laws, including the Securities Exchange Act of 1934, is concerned that this decision will have serious adverse effects both on the enforcement of the federal securities laws by the Commission and on the maintenance of private rights of action under these laws.

Such private actions serve as a "necessary supplement" to the Commission's own enforcement activities and provide an essential means of redress for injured investors. *Mills v. Electric Auto-Lite Co.*, 396 U. S. 375, 382 (1970); *J. I. Case Co. v. Borak*, 377 U. S. 426, 432 (1964).

On Pages 6 and 7 the Commission states:

The Commission supports the petition for rehearing and rehearing en banc on the question of the meaning of scienter because the Commission believes that the panel's erroneous scienter standard will significantly restrict the coverage of the federal securities laws and thus weaken the protections afforded to the investing public.

2. Assuming that even under the proper definition of the term scienter, the panel was correct in reversing the district court's finding that the accounting firm here acted with scienter, we believe that on rehearing this Court should also reconsider the panel's conclusion that a finding of scienter is required in order to prove a violation of Section 14(a) and Rule 14a-9. The panel decision, which is contrary to the authority on this issue, fails to recognize that, unlike Section 10(b), which the Supreme Court in *Hochfelder* read to require scienter, neither Section 14(a) nor Rule 14a-9 uses language which would even suggest a requirement that the violator must act with scienter.

Section 14(a) grants the Commission authority to prescribe rules relating to proxies as are "necessary or appropriate in the public interest or for the protection of investors * * *." Rule 14a-9(A) prohibits any proxy solicitation which is "false or misleading with respect to any material fact, or which omits to state

any material fact" necessary to make statements not "false or misleading" or to correct earlier statements which have become "false or misleading."

On Pages 8 and 9 the Commission concludes:

> The panel, in concluding that scienter was required in order to hold the accounting firm liable under Section 14(a), placed particular emphasis on its perception of the firm's liability for the erroneous financial statements as being one of secondary liability. The panel thus appears to have viewed the theory of liability of the accounting firm here as that of an aider and abettor rather than that of a principal. That view, however, is erroneous. Indeed, in *Securities and Exchange Commission v. Coffey,* 493 F. 2d 1304, 1315 n. 24 (6th Cir. 1974), *cert. denied,* 420 U. S. 908 (1975), this Court viewed an accountant who prepares a dishonest financial statement as a "primary participant in a violation" rather than a secondary participant, in any event, even assuming that liability here must rest on a theory of aiding and abetting, we believe that, rather than the scienter requirement adopted by the panel, a more appropriate analysis may be found in traditional concepts for secondary liability. *Cf. Securities and Exchange Commission v. Coffey, supra,* 493 F. 2d at 1316; *Securities and Exchange Commission v. Coven,* 581 F. 2d 1020, 1028 (2d Cir. 1978), *cert. denied,* 99 S. Ct. 1432 (1979); *Securities and Exchange Commission v. Management Dynamics, Inc.,* 515 F.2d 801 (2d Cir. 1975).

There can be no question but that the false and misleading audit certified by Peat violates Rule 14a-9(a) of the Commission.

It is noteworthy that the Commission calls attention to the fact that the panel opinion conflicts with our opinion in *Securities and Exchange Commission v. Coffey,* 493 F. 2d 1304, 1315 n. 24 (6th Cir. 1974), *cert. denied,* 420 U. S. 908 (1975), which is in addition to the conflict with *Mansbach v. Prescott, Ball & Turben,* 598 F. 2d 1017 (6th Cir. 1979) and is contrary to the great weight of authority.

It is well settled that the interpretation of a statute by the agency charged with its administration is entitled to considerable weight. *United States v. National Association of Security Dealers,* 422 U. S. 694, 719 (1975), followed in *Andrus v. Shell Oil Co.,* ..... U. S. ..... (No. 78-1815, page 10 slip opinion, decided June 2, 1980, opinion written by Chief Justice Burger).

The panel made short shrift of the Commission's contentions by not even discussing them in its two line order denying the petition for rehearing which stated no reason.

The panel has introduced a new doctrine in securities law namely, of "negligent misrepresentations" which will relieve and exempt a dishonest auditor from legal liability not only from wrongful omissions of pertinent material matters which should have been included as being the very purpose of the audit, but also from the false and fraudulent certification attached to the audit.

In the present case, the victims of the fraud have been deprived of their judgments of restitution against the wrongdoer for over $4,000,000 by the misapplication of the securities law by the panel and its cavalier treatment of the factual findings of a distinguished district judge, which did not deserve that kind of treatment.

Supreme Court, U.S.
FILED
NOV 20 1980
MICHAEL RODAK, JR., CLERK

No. 80-659

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1980

MARY LILLIAN ADAMS, in her own name and on behalf of all other persons similarly situated,

*Petitioners,*

v.

PEAT, MARWICK, MITCHELL & Co.,

*Respondent.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

## BRIEF OF RESPONDENT IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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## The "Questions Presented"

In their "Questions Presented", petitioners misstate the holdings of the court of appeals. The decision below does not put in issue the questions which petitioners seek to present.

As one premise for the questions, petitioners say that the court of appeals held that "an accounting firm knowingly made misstatements" (Pet. p. I). In fact, the court of appeals held that the evidence suggested "a mistake" or "at most" negligence (A-10-11) and did not support a finding of "knowing or reckless wrongdoing" (A-14). Petitioners' other premise is that the court of appeals held that the misstatements were of "material facts" (Pet. p. I). The court of appeals actually held that the mistake was a "minor error at the time" (A-11).

All that is left then is the third question which is simply a claim that this Court should give petitioners another hearing on the evidence with respect to scienter.*

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* Respondent Peat, Marwick, Mitchell & Co. received the petition in the mail on October 22, 1980.

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No. 80-659

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## BRIEF OF RESPONDENT IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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### Statement of the Case

Respondent Peat, Marwick, Mitchell & Co. ("PMM") is a firm of independent certified public accountants. It was held liable for $4,503,385.20 by the district court by reason of a misdescription of contractual restrictions on retained earnings which appeared in one of the footnotes to the 1969 financial statements of Chadbourn, Inc. ("Chadbourn") audited by PMM. The footnote incorrectly stated that Chadbourn was contingently restricted in payment of dividends or other distributions upon its "common" stock when it should have said that the contingent restrictions applied to Chadbourn's "capital" stock.

The misdescription became a bone of contention because of the following sequence of events: (1) the financial statements as at and for the fiscal year ended August 2, 1969 which appeared in Chadbourn's 1969 Annual Report were thereafter reprinted in a March 1970 merger proxy statement for Chadbourn's acquisition of all of the stock of another corporation, Standard Knitting Mills, Inc. ("Standard"), in exchange for a newly issued series of Chadbourn convertible preferred stock; (2) the exchange took place and Chadbourn issued the new preferred stock; (3) almost two years after this transaction, there was a disastrous decline in the market for Chadbourn's principal product which caused Chadbourn to incur an unprecedented loss, wiping out all of its retained earnings; and (4) because of that loss Chadbourn was unable to pay dividends on or redeem the preferred stock it had issued to the former Standard shareholders.

The district court had based its damage award against PMM upon causes of action implied under § 10(b) and § 14(a) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §§ 78j(b), 78n(a) (1976). The court of appeals reversed, holding (i) that the district court's finding that PMM acted with scienter was "clearly erroneous" (A-10) and (ii) that at the time and in the circumstances in which it was made the footnote error in issue was "a minor error" (A-11). The court of appeals concluded that "[t]he evidence simply suggests a mistake, an oversight" (A-11).

> "At most the evidence supports a finding that Peat acted negligently in preparing the financial statements [in issue]." (A-10)*

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* In this brief "(A- )" refers to pages in the appendix to the petition and "(———a)" refers to pages in the joint appendix filed in the court of appeals.

The record amply supports these conclusions by the court of appeals.

PMM audited the financial statements of Chadbourn for its fiscal year ended August 2, 1969 and based upon that audit rendered an opinion dated October 21, 1969. The financial statements and PMM's opinion were prepared for and appeared in Chadbourn's 1969 Annual Report to its stockholders. Later they were reprinted in several other reports including Standard's March 27, 1970 proxy statement. PMM expended approximately 5500-6000 man hours and employed the services of 25 auditors on its examination (736a, 1834a-35a).

There never was any claim or proof by petitioners that any figure in the Chadbourn financial statements was wrong or that those statements did not fairly present Chadbourn's assets and liabilities and its income and expenses.

A bank loan agreement restricted Chadbourn from using a portion of its retained earnings to pay dividends on or purchase its capital stock, including common and preferred. It left approximately $2 million of retained earnings already accumulated by Chadbourn as well as all of its future earnings available for such purposes (A-5; 2212a-14a). An earlier subordinated debenture indenture also restricted the use of retained earnings to pay dividends, but it left unrestricted in excess of $5 million of past earnings and all future earnings (A-6; 2195a).*

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* While petitioners quote the indenture as restricting the ability of Chadbourn or its subsidiaries to pay dividends (Pet. p. 5), they do not note that as far as ability to redeem stock was concerned, the indenture provided only that Chadbourn "will not permit any subsidiary to" redeem stock (2195a). The loan agreement which did restrict use by Chadbourn itself of a portion of its retained earnings to redeem stock, left approximately $2 million of retained

Hugh Freeze, PMM's audit manager, drafted a footnote to Chadbourn's August 2, 1969 financial statements near the end of the audit in September 1969 to include a description of the new loan agreement. In subpart (c) of footnote 7 he incorrectly wrote that the restrictions were applicable to Chadbourn "common stock", rather than its "capital stock." This error in Chadbourn's 1969 Annual Report went undetected by Freeze, by the lawyers for both Chadbourn and Standard, and by other accountants who reviewed the financial statements (2028a-29a). Petitioners' own expert testified with respect to the mistaken use of "common" that

> "at the time of the financial statements themselves, as of August 2, 1969, and when the opinion was rendered, there was very little preferred stock outstanding, so that this is a matter of immateriality probably. I mean, it is a mistake technically, it should have said capital, but it's not a material error." (1206a)*

Chadbourn's financial statements were reprinted in the back of the March 27, 1970 Standard proxy statement. Chadbourn's outside counsel, Herbert Browne of the Charlotte firm Helms, Mulliss & Johnston,** noticed the footnote

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earnings plus all future earnings available for that purpose and would expire in 1974 (A-5) one year before the 1975 date when Chadbourn would begin to redeem some of petitioners' stock.

* At the time Chadbourn had outstanding only an immaterial amount of preferred stock the annual dividends on which amounted to approximately $13,000 (741a). Redemption of all of the shares of such Chadbourn preferred stock would have required only $226,999 (*see* 2204a; 2705a).

** The dissenting opinion in the court of appeals erred in referring to Browne as "Peat's attorney" (A-40) and "Peat's own lawyer" (A-41). Petitioners' counsel by letter (a copy of which is annexed as an appendix to this brief) informed the court of appeals of this error in the dissenting opinion, which they had quoted

error at the 46th page of the proxy statement and telephoned Freeze to inform him of it. Browne also informed Freeze, who had not received a copy of the forepart of the proxy statement, that a correct description of the restrictions had been inserted up front in the text of pages 6 and 7 prior to mailing the proxy statement (A-10; 2044a-47a; 2075a). Freeze corrected the footnote error, changing the word "common" to "capital" in two subsequent proxy statements for proposed transactions between Chadbourn and Continental Strategies Corp. ("Continental") and United Hosiery Mills ("UHM") (2591a; 2532a).

That change was a post-mailing correction of "common" to "capital", as petitioners conceded in the court of appeals. There never was any change of the word from "capital" to "common" as petitioners now claim (Pet. p. 5).*

Standard's management, which was aware of the restrictions on Chadbourn's retained earnings (A-11; 593a-96a; 608a), determined to vote in favor of the exchange with Chadbourn and set forth their voting decision and recom-

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in a suggestion for rehearing, pointing out that "the word 'Peat's' should be 'Chadbourn's' " and that "Mr. Browne was actually attorney for Chadbourn." Petitioners nevertheless repeat the dissent's mistaken reference in their petition (Pet. p. 16).

* The district court apparently believed that the Continental proxy statement was drafted first and that the Chadbourn financial statements in the Standard proxy statement were a mark-up of those in the Continental proxy statement. Having made that error, the district court relied upon as "determinative" (A-57-58) the use of the correct term in an "early draft" of the Continental statement as evidence of guilty knowledge by PMM (*ibid.*). But that chronology is wrong, as is apparent from the documentary record (*e.g.*, 2220a, 2241a; 2710a-11a; 3403a; 2591a), as was demonstrated by PMM in its brief in the court of appeals (at pp. 36-40) and as petitioners acknowledged in the Pre-Trial Order, which provided that Freeze "utilized copies of the printed Standard footnotes in drafting the Continental footnotes" (209a) and not vice-versa.

mendation up front in the text of the Standard proxy statement (2667a-68a; 2672a). They, their families and other insiders, collectively owned up to 40% of Standard stock and obviously did not consider the restrictions significant. Petitioners testified that in deciding to approve the exchange of stock transaction, they

> "relied entirely upon the judgment of the management of Standard Knitting Mills. I thought that they would not recommend to stockholders anything that was not to their advantage." (547a-48a; *accord,* 632a-35a; 640a-41a; 643a-44a; 646a-47a; 659a; 663a-64a).

While Standard lost money in 1969, Chadbourn had experienced increased earnings in 1967-1969. Petitioners understood:

> "that any concern that did not make money would not pay dividends, but I did not think Chadbourn would [not make money]." (550a; *accord,* 637a; 656a-57a; 659a-60a; 664a).

Not one of the petitioners testified to having read and relied upon or been misled by footnote 7 at the back of the proxy statement. The district court dismissed petitioners' cause of action under § 18 of the 1934 Act because they had failed to prove reliance (A-98).

On May 27, 1970, several weeks after the exchange transaction, petitioners as Chadbourn stockholders received the UHM proxy statement, wherein the footnote error had been corrected by Freeze. Mrs. Adams, the representative of the petitioner-class, was "sure" that she read the financial statements in the UHM proxy statement which contained this correction (550a-51a). No complaint was registered at that time; the market price of the Chadbourn stock petitioners acquired had remained stable since the date of the

exchange transaction and, following the footnote correction, increased slightly (3209a).

Chadbourn continued to make money in 1970, with a net profit at year end August 1, 1970 of over $1.3 million (2263a). Two years after the August 2, 1969 financial statements in issue and one and one-half years after the April 1970 exchange transaction, however, "the bottom dropped out of [the] hosiery market" (A-6) and Chadbourn announced in September 1971 a loss of $17,000,000 which wiped out its retained earnings and left it with a capital deficit. Announcement of the loss was followed by a decline in the price of Chadbourn stock and led, over a year later, to the institution of this lawsuit on October 12, 1972 (651a-54a; 551a). Petitioners conceded at trial, in response to PMM's offer of proof, that the 1971 loss was not related to their claim against PMM (1993a-99a).*

After the district court certified the action for class action treatment under Fed.R.Civ.P. 23, Standard, Chadbourn and the other defendants, except PMM, entered into a settlement agreement with petitioners whereby petitioners acquired a controlling interest in a reorganized Chadbourn (121a, 138a-42a; 158a-61a). Freeze, the author of the alleged fraudulent footnote 7(c), was retained as Vice President and Treasurer of the reorganized Chadbourn, and held that position at the time of the trial of this action against PMM (281a-83a; 1999a-2002a).

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* As the court of appeals observed (A-4), the disaster which struck the hosiery market was so large that Chadbourn could not have paid dividends or redeemed its stock even if there had been no contractual restrictions. The 1971 loss reflected price cutting and foreign competition in the hosiery market (3562a) which affected in 1972 a precipitous decline in the market price of most textile stocks (3558a-2). The Standard proxy statement had said that "the increase in demand for hosiery . . . has been remarkable, and there can be no assurance that the current popularity of panty hose will continue." (2691a)

The district court acknowledged that there was no evidence that the footnote error affected the price of Chadbourn stock (A-104), yet awarded damages equal to the entire decline in the price of Chadbourn stock subsequent to petitioners' purchase. It held that "[PMM] is not absolved of liability by asserting plaintiffs did not rely" on the footnote (A-92).

The court of appeals reversed on the ground that the finding of scienter was clearly erroneous and that the footnote error was "minor." It did not reach the additional issues raised by PMM concerning the elements of reliance, loss causation and the statute of limitations. In particular, the court of appeals did not reach the issue posed by PMM's argument that "the specific remedy provided by section 18 [of the 1934 Act] precludes implication of a cause of action under either section 10 or section 14, when the requirements of section 18 are not met." (A-13 n.6)*

* A copy of pages 8-10 of PMM's brief in the court of appeals setting forth the questions presented there is annexed beginning at page 3A as an appendix to this brief. There were also findings made by the district court with respect to the methodology used by PMM in its audit which were reversed by the court of appeals and which are not subject to any questions here.

## I

**The Decision of the Court of Appeals to Reverse a Judgment Under Section 10(b) Where the Evidence Showed a "Minor Error" and Negligence "At Most" Does Not Present A Question Justifying Review by This Court.**

As has already been shown (p. i, *supra*), the "Questions Presented" posed by the petitioners are not in fact presented on this record. In addition, as is demonstrated here and in Point II, there is no conflict between the decision of the court of appeals and any decision of this Court or any other court of appeals. Further, as is demonstrated in Point III the holding of the court of appeals that the finding of scienter by the district court was clearly erroneous does not warrant review.

In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), this Court held that an action for damages will not lie under § 10(b) in the absence of proof of an "intent to deceive, manipulate, or defraud" (425 U.S. at 193), and that a complaint under § 10(b) should be dismissed when "respondents conceded that they did 'not accuse Ernst & Ernst of deliberate, intentional fraud,' merely with 'inexcusable negligence'" (425 U.S. at 190 n.5).

Petitioners assert (Pet. p. 10) that "knowledge" is sufficient to establish scienter, but the *Hochfelder* standard is "knowing or intentional *mis*conduct," 425 U.S. at 197 (emphasis added)—the issue is what is it that is "known." The court of appeals said "[a]t most the evidence supports a finding that Peat acted negligently" (A-10). Even when Freeze learned of the mistake in the footnote it appeared to be and was a "minor error" (A-11). That ends any inquiry under *Hochfelder*.

Petitioners ignore these conclusions and claim that the court of appeals erred because it "defined scienter as embracing a 'desire to deceive' " and noted the absence of any proof of a "purpose or desire" on PMM's part to mislead (Pet. pp. 9-10). Concededly the footnote was inaccurate, and the question was whether there was sufficient proof on the record to support the district court's finding that the inaccuracy was the result of deliberate deception by PMM, or rather a slip of the pen, a mistake, a failure to foresee a problem. In analyzing that issue the court of appeals asked, first, whether there was any reason for PMM to *want* to deceive Standard's shareholders, and it found that there was no proof of any such motivation on PMM's part.

Moreover, the court of appeals concluded that the matter misdescribed was not such as would have led the author of the mistake when he came to know of it to view it as material.

> "Freeze did not foresee that the bottom would drop out of Chadbourn's earnings and that what appeared to be a minor error at the time would become a major bone of contention." (A-11)

Rather than constituting any departure from this Court's holding in *Hochfelder*, the court of appeals' approach was a precise application of that holding.

Petitioners' reference (Pet. p. 11) to the statement in *Hochfelder* that the Court did "not address here, the question whether, in some circumstances, reckless behavior is sufficient" (425 U.S. at 194 n.12) has no relevance to this case. While most courts of appeals have adopted a recklessness standard in some circumstances, no court has equated recklessness with negligence. *See, e.g., McLean* v. *Alexander*, 599 F.2d 1190 (3d Cir. 1979), upon which peti-

tioners rely (Pet. p. 11), where the Court of Appeals for the Third Circuit reversed a post-trial judgment for plaintiffs in a § 10(b) action against accountants. The Third Circuit accepted that under *Hochfelder* "negligence—whether gross, grave or inexcusable—cannot serve as substitute for scienter" (599 F.2d at 1198).*

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* *Compare* the decisions from other courts upon which petitioners rely. In *Edward J. Mawod & Co.* v. *SEC*, 591 F.2d 588, 595 (10th Cir. 1979), defendants engaged in actions "designed to raise the price of the stock" and the court held that evidence of "[k]nowledge of the illegality of the scheme is, of course, essential. . . ." In *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978), the defendant fiduciary was informed that his principal's investment adviser was purchasing "junk" stocks for the principal's account and yet "constant[ly] reassur[ed]" the principal that such stocks were "satisfactory." In *Nelson* v. *Serwold*, 576 F.2d 1332, 1337-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978), defendants knew the price at which they had offered to purchase stock from plaintiff was far below value and had "[k]nowledge of plaintiff's assumption that [it] represented the fair market value. . . ." In *SEC* v. *Falstaff Brewing Corp.*, [Current] CCH Fed.Sec.L.Rep. ¶ 97,505 (D.C.Cir. 1980), the court rejected the defense that defendant did not know his actions were in violation of certain law because he had admitted that "he thought that the [proxy] statement was fraudulent" and "elected to say nothing about it" (*id.* at 97,633). Indeed, the SEC had informed the defendant prior to distribution that it deemed a proxy statement to be "materially deficient" but the defendant amended it to say "the [SEC] had 'no comment' on the proxy statement" (*id.* at 97,639). The court held that whether or not the defendant had knowledge of the legal "labels" which would be placed on the facts was not relevant because he had knowledge of the "consequences of those actions" sufficient to support a finding of scienter (*id.* at 97,641). No such evidence was adduced by petitioners in this case.

## II

**The Decision of the Court of Appeals to Reverse a Judgment Against Independent Accountants Under Section 14(a) Where the Evidence Showed a "Minor Error" and Negligence "At Most" Does Not Present A Question Justifying Review by This Court.**

The court of appeals held that the footnote error was a "minor error at the time" (A-11). There can be no liability under § 14(a) on the part of anyone for an immaterial misstatement. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). Accordingly, even if petitioners' questions concerning the standard of culpability arose on this record, the outcome in the court of appeals would not change.

Even if a material error had been involved, the decision of the court of appeals concerning liability under § 14(a) on the part of independent accountants is consistent with decisions of other courts which have addressed the issue in similar contexts. "Section 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them." *Browning Debenture Holders' Committee* v. *DASA Corp.*, 72 Civ. 1332, at 4 (S.D.N.Y. 1975), *aff'd in relevant part*, 560 F.2d 1078 (2d Cir. 1977), *Accord, In re Clinton Oil Co. Securities Litigation*, [1977-78] CCH Fed.Sec.L.Rep. ¶ 96,015 at 91,576 (D. Kan. 1977); *Gould* v. *American Hawaiian Steamship Co.*, 351 F.Supp. 853, 866 (D. Del. 1972).

The court of appeals noted that "section 18 of the 1934 Act, dealing with misstatements in reports filed with the SEC, requires both scienter and reliance for civil liability" and "proxy materials must be filed in advance of the solicitation with the SEC, *see* 17 C.F.R. § 240.14a-6." (A-13 n.6) Section 18 of the 1934 Act, unlike § 14(a), applies to "any person who shall make or cause to be made a misleading

statement" in, *inter alia,* a proxy statement, and it was expressly contemplated that § 18 would provide the cause of action for misstatements by accountants contained in filed reports.* On the other hand, § 14(a) was thought to be addressed only to election proxy contests and the like, not to accountants, nor was it thought to create any civil liability. When, in 1934, the accounting profession presented its views with respect to the dimensions of private liability under the 1934 Act it addressed itself to § 18 and it objected to the original version which contemplated a negligence standard "on the ground that liability would be created for honest errors in judgment," *Hochfelder,* 425 U.S. at 211 n.31. The standard accordingly was changed to its present formulation imposing liability only for scienter.

As petitioners state (Pet. p. 15), the court of appeals "placed particular emphasis on its perception of the respondent's liability . . . as being one of secondary liability." Traditional concepts of secondary liability require proof that the defendant has "knowingly" and substantially assisted "a securities law violation" by another.**

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* *See Hochfelder,* 425 U.S. at 211-12n.31; Conf. Rep. to H.R. 9323, H.R. Rep. No. 1838, 73d Cong., 2d Sess. at 36 (1934); 78 Cong. Rec. 8040 (1934) (remarks of Rep. Rayburn and Rep. Hollister).

** *SEC* v. *Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975). *Accord, Hirsch* v. *du Pont,* 553 F.2d 750, 759 (2d Cir. 1977) ("knowledge of the fraud, and not merely the undisclosed material facts, is indispensable" to establish aiding and abetting liability); *Woodward* v. *Metro Bank,* 522 F.2d 84, 94-97 (5th Cir. 1975); *Landy* v. *FDIC,* 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974). In *Investors Research Corp.* v. *SEC,* 628 F.2d 168, 176-78 (D.C. Cir. 1980), the court affirmed an order censuring the principal defendant for negligent violation of § 17 of the Investment Advisors Act but reversed the order as to the alleged aider and abettor because of the absence of evidence of the requisite "state of mind". The court held that as to the alleged aider and abettor there must be evidence of "knowledge of wrongdoing" and "awareness that [the aider and abettor] was assisting . . . in wrongful conduct."

Petitioners say (Pet. p. 14) that "[t]o petitioners knowledge, except for the decision of the panel in this case, no other federal court has ruled that scienter, rather than negligence, is required," citing *Gould* v. *American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976). In fact, the court in *Gould* held that substantial shareholders who had designated members of the Board of the company which engaged in a proxy solicitation—persons more closely associated with the soliciting company than independent accountants—could be liable under § 14(a) only as "aiders and abettors." The test it laid down was that:

> "plaintiffs would have the burden of proving the doing of a wrongful act, the alleged aiders' and abettors' knowledge of it and their knowing and substantial participation in the wrongdoing." (535 F.2d at 779)*

The district court below held that PMM had acted with scienter and "therefore aiding and abetting a proxy solicitation" (A-97). The court of appeals, however, found no evidence of any "knowing or reckless wrongdoing" on the part of PMM (A-14).

Petitioners say (Pet. p. 15) that the application of standards of secondary liability in this case conflicts with *Standefer* v. *United States*, 100 S.Ct. 1999 (1980). They do not explain the pertinence of *Standefer* which involved a statute which expressly rendered "all participants in conduct violating a federal criminal statute . . . 'principals'," 100 S.Ct. at 2006, referring to 18 U.S.C. §2 (1976).

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* In *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298 n.16 (2d Cir. 1973), which petitioners also cite (Pet. pp. 14-15), the court made it clear that it was not passing "on the principles that should govern liability [under § 14(a)] of directors and other individuals having some responsibility for [a proxy] statement, as distinguished from a controlling corporation which has been the beneficiary of the action that was induced." *See also Hochfelder*, 425 U.S. at 209 n.28.

No such statute exists in respect of civil liability under the federal securities laws.*

Section 14(a) forbids the solicitation of proxies in contravention of such rules as may be promulgated by the SEC. It does not set forth the degree of culpability required to violate it. The SEC Rule 14a-9 tells us nothing of Congressional intent. There is no analogy to be drawn (*see* Pet. pp. 13-14) between that Rule and the statute involved in *Aaron* v. *SEC,* 100 S.Ct. 1945 (1980). As this Court responded to a similar attempt to divine congressional intent from an SEC rule, "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law," *Hochfelder,* 425 U.S. at 213.

The legislative history reveals that in enacting § 14(a) Congress intended to protect existing shareholders of a corporation from the same manner of "manipulative," "unscrupulous" and "promiscuous" conduct in the context of contests for corporate control as it had proscribed in

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* Petitioners also cite to *SEC* v. *Coffey, supra,* 493 F.2d 1304, as support for their assertion that an accountant can be "a primary participant in a violation" (Pet. p. 15), but do not explain that it involved an action under § 10(b) which, in contrast to the limited focus of § 14(a), applies by its terms to "any person" who "use[s] or employ[s], in connection with the purchase or sale of any security . . . any manipulative or deceptive device."

In *Hochfelder* this Court left open the question whether liability may be assessed against aiders and abettors in private civil actions under the federal securities laws, 425 U.S. at 191 n. 7, and thus it is unclear whether there is any basis at all to hold an independent accountant liable under § 14(a). In 1959 the SEC proposed that Congress add aiding and abetting provisions to the 1933 Act and the 1934 Act, but even then made it clear that those provisions would only apply to SEC administrative proceedings or enforcement actions and that "no civil liability is intended." *SEC Legislation: Hearings on S. 1178, et al. Before a Subcomm. of Sen. Comm. on Banking and Currency,* 86th Cong., 1st Sess. at 288 (1959). The Senate passed such a bill, S. 3769, 3770, 86th Cong., 2d Sess. (1960), but the House never voted on it.

§ 10(b) in connection with purchases and sales of securities, *see* A-14-15. This intent is confirmed by the legislative history of § 14(e), *see* A-15-17. The court of appeals correctly concluded (A-13, A-17) that it was particularly appropriate to apply such a standard in this case against independent accountants.

## III

**The Decision of the Court of Appeals That the District Court's Finding of Fraud Was "Clearly Erroneous" Does Not Present A Question Justifying Review by This Court.**

This Court has held that "'A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.' *United States* v. *United States Gypsum Co.*, 333 U.S. 364, 395." *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 (1960).

The court of appeals reviewed the entire record, which was extensively briefed by the parties, and concluded that the district court's finding of fraud was "clearly erroneous" (A-10). All that petitioners present here is the dissenting judge's view of the evidence with respect to the issue of scienter.

A writ of certiorari should not be issued "merely to give the defeated party in the Circuit Court of Appeals another hearing," *Magnum Import Co.* v. *Coty*, 262 U.S. 159, 163 (1923), or "to review evidence and discuss specific facts," *United States* v. *Johnston*, 268 U.S. 220, 227 (1925).

## CONCLUSION

The petition should be denied.

Respectfully submitted,

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November 20, 1980

# APPENDIX

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MACEY & ZUSMANN
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1795 Peachtree Road, Northeast
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May 16, 1980

Mr. John P. Hehman, Clerk
Office of the Clerk
United States Court of Appeals
for the Sixth Circuit
Room 502
Post Office and Courthouse Building
Cincinnati, Ohio 45202

Re: CASE No. 78-1111-2

Mary Lillian Adams, et al., Plaintiffs-Appellees,
Barry J. McKean, et al., Paul W. Mankin, et al.,
Intervenors-Appellees,

vs.

Standard Knitting Mills, Inc., et al., Defendants,
Peat, Marwick, Mitchell and Company, Defendant-
Appellant

Dear Mr. Hehman:

Please note to the Court that, on page 9, line 5 of the SUGGESTION FOR REHEARING EN BANC AND PETITION FOR REHEARING, filed May 15, 1980, the word "Peat's" should be "Chadbourn's".

The quotation itself is accurate, but Mr. Browne was actually attorney for Chadbourn (App. 709a, 2044a, 2271a, 2595a).

Very truly yours,

/s/ JOHN M. SIKES, JR.
John M. Sikes, Jr.
Attorney for Plaintiffs-Appellees

JMSjr:mc
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Victor M. Earle, III, Esq.
Richard I. Miller
Donald F. Paine, Esq.
Louis A. Craco, Esq.

**"Questions Presented", From Pages 8-10 of the Brief of Respondent Peat, Marwick, Mitchell & Co. in the Court of Appeals**

1. As to the footnote: Was the footnote to Chadbourn's August 1969 financial statements materially misleading in view, *inter alia,* of the accurate description of the pertinent restrictive covenants in the forepart of Standard's 1970 proxy statement? Was the footnote materially wrong when the Chadbourn preferred stock was not outstanding at the date of Chadbourn's August 1969 financial statements to which PMM's 1969 opinion related? Were there material restrictions on the redemption of Chadbourn's preferred stock? Did PMM intend to deceive the Standard stockholders?—Point I, *infra.*

2. As to Chadbourn's computer operations: Did PMM have a duty to publicly disclose weaknesses in Chadbourn's internal controls? Were there material weaknesses in Chadbourn's internal controls which affected the reliability of its accounting records? Did PMM intend to deceive the Standard stockholders?—Point II A, *infra.*

3. As to PMM's audit: Does failure to completely adhere to generally accepted auditing standards ("GAAS") provide the basis for a fraud action against accountants in the absence of any showing that the financial statements they examined were inaccurate? Did PMM's audit fail to comply with GAAS? Did PMM intend to deceive the Standard stockholders?—Point II B, *infra.*

4. As to proxy solicitation: Did the inclusion of PMM's opinion concerning Chadbourn's 1969 financial statements in the 1970 proxy statement constitute PMM an aider and abettor of a wrongful proxy solicitation, when no liability

on the part of Chadbourn, Standard or anyone else was found? Is there an implied right of action under Section 14(a) for the purchase of stock in a merger when an express right of action is provided by Section 18 of the 1934 Act? Point III, *infra.*

5. As to reliance and causation: May it be conclusively presumed that Standard's stockholders relied upon the footnote or PMM's opinion, despite the uncontroverted evidence to the contrary and the district court's dismissal of the express cause of action provided plaintiffs by Section 18 of the 1934 Act because they failed to prove reliance upon the matters complained of? May plaintiffs whose express cause of action under Section 18 has been dismissed for want of proof of reliance recover under an implied cause of action under either Section 10(b) or Section 14(a) by conclusively presuming reliance to follow from materiality? Is an action founded upon an accountant's opinion one involving primarily non-disclosure or is it rather one of misrepresentation where proof of reliance is required?—Point IV, *infra.*

6. As to injury and damages: May PMM be held liable for the decline in the price of Chadbourn's stock in the two and one-half years between the date of the merger and the date the action was filed?—Point V, *infra.*

7. May the fees of plaintiffs' attorneys be assessed as a "penalty" against PMM? Was the award of prejudgment interest an abuse of discretion?—Point VI, *infra.*

8. Was plaintiffs' claim barred by the applicable statute of limitations?—Point VII, *infra.*